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VIA FEDERAL EXPRESS

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Exemptive Application Pursuant to Rule 612(c) of Regulation NMS – BX Proposed Retail Price Improvement (RPI) Program

Dear Mr. Fields:

Pursuant to Rule 612(c) of Regulation NMS ("Reg NMS") under the Securities Exchange Act of 1934 (the "Exchange Act"), NASDAQ OMX BX, Inc. ("BX" or the "Exchange") requests that the Securities and Exchange Commission (the "Commission") exempt the Exchange and Retail Price Improvement Orders ("RPI") entered under the Exchange's Retail Price Improvement (RPI) Program (the "Program")[1] from the provisions of Rule 612 (the "Sub-Penny Rule" or the "Rule") that prohibit a national securities exchange from accepting or ranking certain orders based on an increment smaller than the minimum pricing increment.[2] We believe the Program

[1] The Program is contained in proposed BX Rule 4780 (the "proposed Rule"), which has been filed with the Commission concurrently with this exemptive application.

[2] This exemptive application seeks exemptions pursuant to Rule 612(c) of Regulation NMS similar to the exemptive relief granted by the Commission to NASDAQ, NYSE and NYSE Amex, and BATS Y-Exchange ("BATS"), *see* Securities Exchange Act Release No. 68836 (December 3, 2012), 77 FR 73097, 73100 (December 7, 2012) (SR-

has the potential to offer superior execution prices to retail investors and to encourage price competition for retail orders among liquidity providers under the Program. Further, the non-displayed RPI Orders would not implicate any of the concerns that the Sub-Penny Rule was designed to address. Accordingly, as set forth below, the exemption would serve to promote the public interest and protect investors.

Background to the Proposed Retail Price Improvement Proposal.

The Exchange believes that the quality of our markets and the accuracy of price discovery depend on the interaction among a diverse set of market participants, including short-term, long-term, retail and institutional investors. The interaction among these participants has been reduced as long-term investors execute orders in an increasingly diverse array of execution venues. The Exchange continues to fully embrace fair competition among exchanges and other market centers and acknowledges the positive trading experience that retail investors enjoy in today's marketplace. At the same time, we support the Commission's efforts to examine the impact of fragmentation on market quality, price discovery and retail investor protection.[3] We also believe that the RPI Program represents an opportunity to take an important step in the direction of greater price competition for retail orders.

The Proposed RPI Program.

Participants, Incentives and Order Types. The Exchange expects to file a proposed rule change with the Commission to establish a RPI Program on a pilot basis[4] to attract additional retail order flow to the Exchange for all Reg NMS securities. The Program is designed to provide a new participant type ("Retail Member Organizations") with maximum price improvement through the functioning of a competitive marketplace composed of a broad spectrum of market participants.

- ***Retail Member Organization*** ("RMO"). An RMO is a member organization approved by the Exchange to submit Retail Orders pursuant to the Program. To qualify as an RMO,

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NASDAQ-2012-129 Notice); *see also* Securities Exchange Act Release No. 34-67347 (July 3, 2012), 77 Fed. Reg. 40673 (July 10, 2012); and *see also* Securities Exchange Act Release No. 68303 (November 27, 2012), 77 FR 71652 (December 3, 2012) ("RPI Approval Order") (SR-BXY-2012-019).

3 *See* Speech by Chairman Mary L. Shapiro "*Strengthening Our Equity Market Structure,*" September 7, 2010 referencing reports of retail broker-dealers that individual investors have retreated from the equity markets since May 6, 2010 and mutual fund data reflecting a pattern of an outflow of funds from equity mutual funds since the events of that day.

4 The proposed pilot period would extend twelve months from the date of implementation of the Program, which would occur no later than 90 days after Commission approval of BX Rule 4780. The Program would expire on a date to be determined upon adoption of the proposed Rule.

a member must conduct a retail business or handle retail orders on behalf of another broker-dealer. An RMO must submit an attestation that any order it submits will qualify as a Retail Order and provide supporting documentation sufficient to demonstrate the retail nature and characteristics of the applicant's order flow. The Exchange may disqualify an RMO for submitting orders designated as Retail Orders that fail to meet the requirements of the Program, subject to the process set forth in the proposed Rule. In exchange for submitting Retail Orders through the Program, an RMO will receive favorable economics for accessing liquidity in the form of a per share rebate.

• ***Retail Order.*** A Retail Order is an agency or riskless principal order originating from a natural person, submitted by the RMO pursuant to the Program without modification with respect to price (except where a market order is converted to a marketable limit order) or side of market, and not generated by a trading algorithm or other computerized methodology. Retail Orders are by definition Immediate or Cancel ("IOC") orders that may interact, in accordance with the RMO's instructions, with (1) liquidity in the Program, (2) other interest in BX systems, and (3) liquidity residing on away markets. Importantly, Retail Interest will always interact with resting liquidity in such a way that would maximize the price improvement to the RMO. For example, a Retail Order will interact with a resting midpoint pegged order before a less aggressively priced RPI Order.

• ***Retail Price Improvement Order.*** An RPI consists of non-displayed interest in Reg NMS securities that is: priced better than the Protected National Best Bid ("NBB") or Protected National Best Offer ("NBO") [5] by at least $0.001 and available to interact exclusively with Retail Orders entered by an RMO.[6] An RPI may be entered by any BX Member. RPI Orders can be priced either as an explicitly priced limit order or implicitly priced as relative to the National Best Bid and Offer ("NBBO") with an offset of at least $0.001. The price of an RPI Order with an offset would be determined by a Member's entry of the following into the Exchange: (1) RPI buy or sell interest; (2) an offset of the Protected NBBO, if any, and (3) a ceiling or floor price. RPI Orders submitted with an

5 The term Protected Quotation is defined in Chapter XII, Sec. 1(19) and has the same meaning as is set forth in Regulation NMS Rule 600(b)(58). The Protected NBBO is the best-priced protected bid and offer. Generally, the Protected NBBO and the national best bid and offer ("NBBO") will be the same. However, a market center is not required to route to the NBBO if that market center is subject to an exception under Regulation NMS Rule 611(b)(1) or if such NBBO is otherwise not available for an automatic execution. In such case, the Protected NBBO would be the best-priced protected bid or offer to which a market center must route interest pursuant to Regulation NMS Rule 611.

6 The Exchange recognizes that sub-penny trading and pricing could potentially result in undesirable market behavior. The Exchange will monitor the Program in an effort to identify and address any such behavior.

offset would be similar to other peg orders available to Members in that the order is tied or "pegged" to a certain price, and would have its price automatically set and adjusted upon changes in the Protected NBBO, both upon entry and any time thereafter. The Exchange expects that RPI sell or buy interest typically would be entered to track the Protected NBBO, that is, RPI Orders typically would be submitted with an offset. The offset would be a predetermined amount by which the Member is willing to improve the Protected NBBO, subject to a ceiling or floor price. The ceiling or floor price would be the amount above or below which the Member does not wish to trade. RPI Orders in their entirety (the buy or sell interest, the offset, and the ceiling or floor) will remain non-displayed. The Exchange will also allow Members to enter RPI Orders which establish the exact limit price, which is similar to a non-displayed limit order currently accepted by the Exchange today except the Exchange will accept sub-penny limit prices on RPI Orders in increments of $0.001. The Exchange will monitor whether RPI buy or sell interest, adjusted by any offset and subject to the ceiling or floor price, is eligible to interact with incoming Retail Orders.

Retail Order Designations. An RMO can designate how a Retail Order would interact with available contra-side interest as follows. As proposed, a Type 1-designated Retail Order would interact only with available contra-side RPIs and other price-improving non-displayed liquidity. It would therefore not interact with other available displayed contra-side interest or non-displayed interest at the NBBO in BX systems or route to other markets.

The portion of a Type 1-designated Retail Order that does not execute would be immediately and automatically cancelled.

A Type 2-designated Retail Order would interact first with available price-improving liquidity as per above, and any remaining portion of the Retail Order would be executed, if possible, as a Reg NMS-compliant IOC order pursuant to BX Rule 4757. Accordingly, a Type 2-designated Retail Order could interact with other interest in BX systems, and could further include instructions to route to other markets depending on the instructions of the order.

Retail Liquidity Identifier. The Exchange proposes to disseminate an identifier through proprietary data feeds when RPI interest priced at least $0.001 better than the NBBO for a particular security is available in BX systems ("Retail Liquidity Identifier"). The Retail Liquidity Identifier would also be disseminated to the Securities Information Processors via the Consolidated Quotation System and Unlisted Trading Privileges Quote Data Feed.

Priority and Order Allocation. As discussed below, RPI Orders will be ranked and allocated according to price and time of entry into the System consistent with BX Rule 4757 and therefore without regard to whether the size entered is an odd lot, round lot or mixed lot amount. Only, Retail Orders will interact with RPI Orders, although they may also interact with other price-improving orders if any is available on the Exchange (*e.g.*, non-display liquidity priced more aggressively than the NBBO) according to the Priority and Allocation rules of the Program. Retail Orders may further interact with other liquidity on the Exchange or on other market centers depending on the specific instructions of that order (*i.e.*, each may be designated as Type 1 or Type 2, as per the discussion above).

RPI Orders would interact with Retail Orders as follows. Assume a Member enters a RPI Order to sell 100 shares with an offset of $0.001 and a floor of $10.10 while the Protected NBO is $10.11. The RPI Order could interact with an incoming Retail Order to buy 100 shares at $10.109. If, however, the Protected NBO was $10.10, the RPI Order could not interact with the Retail Order because the price required to deliver the minimum $0.001 price improvement ($10.099) would violate the Member's floor of $10.10. If a Member otherwise enters an offset greater than the minimum required price improvement and the offset would produce a price that would violate the Member's floor, the offset would be applied only to the extent that it respects the Member's floor. By way of illustration, assume RPI buy interest is entered with an offset of $0.005 and a ceiling of $10.112 while the protected NBB is at $10.11. The RPI Order could interact with an incoming sell Retail Order at $10.112 because it would produce more than the amount of price-improvement required under the rule without violating the Member's ceiling, but it could not interact above the $10.112 ceiling. Finally, if a Member enters an RPI Order without an offset (*i.e.*, an explicitly priced limit order), the RPI Order will interact with Retail Orders at the level of the Member's limit price as long as the minimum required price improvement is produced. Accordingly, if RPI sell interest is entered with a limit price of $10.098 and no offset while the Protected NBO is $10.11, the RPI Order could interact with the Retail Order at $10.098 producing $0.012 of price improvement. The System will not cancel RPI interest when it is not eligible to interact with incoming Retail Orders. Such RPI interest will remain in the System and may become eligible again to interact with Retail Orders depending on the Protected NBBO.

The Sub-Penny Rule Was Designed to Deal with Concerns Related to Public Display or Private Communication of Quotes in Sub-Penny Increments, Concerns Which Are Not Implicated by the RPI Program's RPI Orders.

The Sub-Penny Rule establishes a minimum pricing increment for Reg NMS stocks providing in pertinent part that national securities exchanges, ATSs, vendors, brokers and dealers shall not display, rank, or accept from any person a bid or offer, an order, or an indication of interest in any Reg NMS stock priced in an increment smaller than $0.01 if that bid or offer, order, or indication of interest is priced equal to or greater than $1.00 per share.[7]

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[7] Rule 612(a) of Reg NMS.

The Rule similarly establishes a minimum increment of $0.0001 for orders priced less than $1.00 per share.[8]

The Rule further provides that the Commission may, by order, exempt

> any person, security, quotation, or order, or any class or classes of orders of persons, securities, quotations, or orders, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.[9]

At the core of the Rule's purpose was the Commission's concern with the potential of sub-penny increments to erode the incentives of investors to display limit orders. The Commission proposed the Rule in an effort to "limit the ability of a market participant to gain execution priority over a competing limit order by stepping ahead by an economically insignificant amount."[10]

Among the related concerns associated with sub-penny quoting referenced by the Commission in adopting the Sub-Penny Rule were: (1) the possible decrease in market liquidity attributable to a reduced use of limit orders by investors; (2) the erosion of customer protections such as exchange priority rules and Manning where market participants could gain execution priority over a limit order for an "infinitesimally small" increment[11]; (3) flickering quotations resulting

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8 Rule 612(b) of Reg NMS.

9 Rule 612(c) of Reg NMS.

10 Securities Exchange Act Release No. 34-51808, 70 Fed. Reg. 37496, 37551 (June 29, 2005) ("NMS Adopting Release").

11 It is important to view the Commission's characterization of sub-penny increments as economically insignificant as tied closely to the particular systemic benefits that displayed limit orders bring to price competition. "[T]he Commission agrees with the many commenters who believed that prohibiting sub-penny quoting would deter the practice of stepping ahead of exposed trading interest by an economically insignificant amount. Limit orders provide liquidity to the market and perform an important price-setting function. If a quotation or order can lose execution priority because of economically insignificant price improvement from a later-arriving quotation or order, liquidity could diminish and some market participants could incur greater execution costs." NMS Adopting Release at 37588. In other words, the increment was seen as trivial in relation to the important systemic risks it presented. It was price competition driven by displayed, exposed orders that concerned the Commission, not undisplayed orders like the RPIs. Moreover, the Commission did not view the price improvement produced as a result of sub-penny executions as trivial. Rather, the language quoted infra at page 6 from the Adopting Release makes clear that the Commission recognized sub-penny executions as "generally beneficial." In any event, the Exchange believes that the

from widespread sub-penny pricing and attendant best execution concerns; (4) a potential decrease in market depth at the inside; and (5) potentially increased incentives on the part of institutions, given reduced depth at the inside, to rely on execution alternatives "away from the exchanges and Nasdaq" and the increased fragmentation that such incentives could drive.[12]

Importantly, both the core concern the Sub-Penny Rule sought to address – the displayed limit order's loss of priority to an insignificantly better price – and the additional concerns related to liquidity, best execution, capacity, and fragmentation relate to sub-penny quoting and not sub-penny trading. The Commission drew the distinction plainly in the Adopting Release and went on to flag the particular benefit of sub-penny executions to retail investors:

> The Commission believes at this time that trading in sub-penny increments does not raise the same concerns as sub-penny quoting. Sub-penny executions do not cause quote flickering and do not decrease depth at the inside quotation. Nor do they require the same systems capacity as would sub-penny quoting. In addition, sub-penny executions due to price improvement are generally beneficial to retail investors.[13]

Pursuant to the RPI Program, neither Retail Orders nor RPIs will be displayed by the Exchange. Retail Orders by definition will be IOC orders. RPIs are defined as consisting of "non-displayed liquidity on BX that is priced better than the Protected NBBO by at least $0.001" by proposed BX Rule 4780(a)(2) and (3).[14] Accordingly, the nature of the proposed order types simply does not give rise to the concerns addressed by the Sub-Penny Rule. There would be no potential for them to step ahead of any displayed order, to jeopardize the incentives to place limit orders, or to otherwise implicate the customer protection, capacity, best execution, liquidity and fragmentation concerns addressed by the Sub-Penny Rule. In addition, the Program would actually serve to encourage the additional display of liquidity in the marketplace and would not detract from the quality of orders in the marketplace as raised in Reg NMS.

Similarly, while the Exchange would "accept" and "rank" non-displayed RPIs using increments less than the minimum pricing increment as described above, doing so would in no way undermine the purpose or framework of the Sub-Penny Rule. Indeed, the prohibition on the acceptance and ranking based on sub-pennies was directed at the practice of private sub-penny

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minimum price improvement available under the Program, which would amount to $0.50 on a 500 share order, would be meaningful to the small retail investor.

12 NMS Adopting Release at 37551-52.

13 NMS Adopting Release at 37556.

14 RPIs in their entirety (buy or sell interest, any offset, and the ceiling or floor) will remain undisplayed.

display that had developed on ECNs in the wake of decimalization.[15] Some ECNs during that period were accepting, ranking and privately displaying sub-penny orders to subscribers while at the same time (then pre-exchange) Nasdaq and the exchanges were requiring their members to quote in pennies and the public quote stream reflected those quotes only in pennies. The Commission expressed concern that this lack of uniformity was "creating hidden markets whereby sophisticated traders [could] view and access better prices than those available to the general public."[16] The Sub-Penny Rule's prohibition on accepting and ranking sub-penny orders is therefore best understood as an effort to address and prevent the development of private or hidden markets with better-priced sub-penny orders. Because the RPI Orders would remain at all times entirely non-displayed, they present no risk that a hidden sub-penny market would develop. Rather, the whole point of the RPI Program is *to make better prices available to the general public by fostering competition on public markets for retail orders.*

The Proposed Exemption Would Protect Investors and Otherwise Serve the Public Interest Because It Would Enhance Price Competition for Retail Orders And Would Offer A More Robust Regulatory and Surveillance Environment for the Execution of Retail Order Flow.

The RPI Program Would Enhance Price Competition for Retail Orders. The potential for enhanced price competition would be created by the following incentives. Members would be attracted to submit RPIs because they could (1) interact with retail order flow; and (2) trade at sub-penny increments in an exchange environment.

Member organizations handling retail flow would have an incentive to become RMOs because of (1) the presence of a diverse community of market participants competing on the basis of price improvement to execute their customers' orders; (2) the economic benefit of the per share credit offered under the Program; (3) the likely increased comfort that the Exchange's operation and regulation would provide RMOs with respect to best execution; and (4) the ability to receive price improvement on all Reg NMS securities priced above $1.

The most aggressive Members in terms of price improvement would be rewarded with executions under the Program. RMOs, if price competition for Retail Orders develops as expected, would see the benefit of the increased competition in execution prices they report back to their customers. Statistics on the improvement of effective spreads would be made available by the Exchange. Individual investors would benefit directly from any improvement in execution prices that the enhanced competition produced.

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15 Securities Exchange Act Release No. 34-49325, 69 Fed. Reg. 11126, 11163-64 (Mar. 9, 2004) ("NMS Proposing Release"). The Commission noted the "growing trend in the industry, particularly among ECNs, to display quotations in their proprietary systems in sub-pennies . . . ." Proposing Release at 11163.

16 NMS Proposal at 11171.

The RPI Program Has the Potential to Increase the Level of Interaction Experienced by Retail Orders. To be sure, the growth of nontransparent liquidity is not simply a market structure issue for the Exchange but a competitive challenge as well. The segmentation of differing order flows by non-exchange venues in particular has presented the Commission for more than a decade with the difficult tension between promoting market center competition on the one hand and promoting order interaction on the other. Clearly, the RPI Program is part of the Exchange's efforts to compete as a market center for the retail order flow that is being internalized away from the Exchange. The Program should also be understood, however, to offer the collateral benefit of improving the order interaction that retail executions experience.

The potential gains in order interaction under the program are three. First, multiple Members typically will be able to interact with every Retail Order submitted by an RMO under the Program. Second, Retail Orders will be eligible to interact with other price-improving liquidity on the BX Book, including midpoint orders. This will increase the economic benefit enjoyed by Retail Investors. Third, Retail Orders under the Program will have the option to interact with the displayed interest on BX as well as other trading venues where there is insufficient RPI liquidity available to completely execute the Retail Order. To the extent that RMOs utilize the Retail Order designations allowing them to check for displayed BX liquidity after finding insufficient price-improving liquidity, the functionality would represent a further advance for potential interaction with retail orders.

The Exchange Offers a Robust Regulatory and Surveillance Alternative to the Existing Oversight of Internalization. The Exchange has been clear in recognizing that certain types of internalization have resulted in positive trading experiences for retail investors. At the same time, we have pointed out our reservations about the current regulatory disparities between registered exchanges on the one hand and ATSs, dark pools, and broker-dealer internalization venues on the other. The current RPI Program proposal illustrates what we believe to be a fair balance for the various market participants. The Program recognizes the economic reality of the short-term profit potential on retail orders from the reduced sensitivity of the typical retail investor to short-term price movements. Accordingly, the Program is premised upon the reliable identification and segmentation of retail flow. The Program has been designed, however, to simultaneously produce aggressive price competition and as much order interaction for the Retail Order as possible.

It is worth underscoring that *every* significant aspect of the Program, including the minimum level of required price improvement and the details of the liquidity maintenance obligations, will be publicly exposed through a rule filing, commented on by any market participant or member of the public who cares to comment, and examined closely by the staff. It will be implemented only if and when approved by the Commission. The credits paid to RMOs and the fees to be charged to Members will as always be subject to the Commission's rule filing process. In addition, the

Exchange will be obligated to ensure that access to the Program is granted on terms that do not permit unfair discrimination. Finally, the trading activity conducted through the Program will be subject to extensive market surveillance pursuant to the Exchange's obligations as a self-regulatory organization. These are all improvements to the current execution landscape. The RPI Program therefore offers a distinct advance in the transparency of current internalization arrangements and the quality of the regulatory effort directed at them.

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No single proposal can reasonably claim to address the myriad of complex challenges associated with the segmentation of retail order flow. That said, the Exchange believes that the RPI Program has the potential to be an important step in the direction of more vibrant price competition for retail flow, a higher degree of order interaction between market participants than occurs today, and the provision of more reliable liquidity. These potential benefits, along with the attraction of internalized liquidity to market centers with greater transparency around their processes and a more robust regulatory framework, are well worth seeking if they contribute even modestly to the confidence of the individual investor in the operation of the equity markets and their pricing mechanism.

For the reasons set forth above, the Exchange respectfully requests an exemption from Reg NMS Rule 612 for the Exchange and RPIs entered, accepted, and ranked pursuant to the proposed RPI Program set forth in proposed BX Rule 4780 because the Program would serve the public interest and otherwise protect investors.

Thank you in advance for your consideration of this request.

Sincerely,

Jeffrey S. Davis
Vice President and Deputy General Counsel