

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-64090; File No. SR-BX-2011-007)

March 17, 2011

Self-Regulatory Organizations; NASDAQ OMX BX LLC; Order Approving a Proposed Rule Change Relating to Permanent Approval of the BX and NES Inbound Routing Relationship

I. Introduction

On January 28, 2011, NASDAQ OMX BX LLC (“BX” or “Exchange”) 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 to permit the Exchange to accept inbound orders that Nasdaq Execution Services, LLC (“NES”) routes in its capacity as a facility of The NASDAQ Stock Market LLC (“Nasdaq”), with certain obligations and conditions. The proposed rule change was published for comment in the Federal Register on February 14, 2011.<sup>3</sup> The Commission received no comment letters regarding the proposed rule change. This order approves the proposed rule change.

II. Background

BX Equity Rule 2140(a) prohibits the Exchange or any entity with which it is affiliated from acquiring or maintaining an ownership interest in a member in the absence of an effective filing under Section 19(b) of the Act.<sup>4</sup> NES is a broker-dealer that is a member of the Exchange, and currently provides to Nasdaq members optional routing

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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. 63859 (February 7, 2011), 76 FR 8391 (“Notice”).

<sup>4</sup> 15 U.S.C. 78s(b).

services to other market centers. NES is owned by The NASDAQ OMX Group, Inc. ('NASDAQ OMX'), which also owns three registered securities exchanges—Nasdaq, the Exchange, and NASDAQ OMX PHLX LLC.<sup>5</sup> Thus, NES is an affiliate of each of these exchanges. Absent an effective filing, BX Equity Rule 2140(a) would prohibit NES from being a member of the Exchange.

On August 7, 2008, in connection with the acquisition of the Exchange by NASDAQ OMX, the Commission, approved an affiliation between the Exchange and NES for the limited purpose of permitting NES to provide routing services for Nasdaq for orders that first attempt to access liquidity on Nasdaq's system before routing to the Exchange, subject to certain other limitations and conditions.<sup>6</sup> At the time of NASDAQ OMX's acquisition of the Exchange, the Exchange was not trading equity securities.<sup>7</sup> On December 23, 2008, in connection with the Exchange's resumption of equity trading, the Commission approved a modification to the conditions for the affiliation between NES and the Exchange, to permit the Exchange to receive orders routed by NES in its capacity

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<sup>5</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) ('BSE Approval Order'). See also Securities Exchange Act Release No. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008) (order approving NASDAQ OMX's acquisition of Phlx.)

<sup>6</sup> See BSE Approval Order, supra note 5.

<sup>7</sup> See BSE Approval Order, supra note 5, 73 FR at 46944, n.117.

as a facility of Nasdaq (including “Directed Orders”),<sup>8</sup> on a one-year pilot basis.<sup>9</sup> The Exchange is now proposing to make such approval permanent.<sup>10</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>11</sup> Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(1) of the Act,<sup>12</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>13</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

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<sup>8</sup> Nasdaq Rule 4751(f)(9) defines Directed Orders as immediate-or-cancel orders that are directed to an exchange other than Nasdaq without checking the Nasdaq book.

<sup>9</sup> See Securities Exchange Act Release No. 59154 (December 23, 2008), 73 FR 80468 (December 31, 2008) (SR-BSE-2008-48) (“BSE Inbound Routing Order”).

<sup>10</sup> See Notice, supra note 3.

<sup>11</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>12</sup> 15 U.S.C. 78f(b)(1).

<sup>13</sup> 15 U.S.C. 78f(b)(5).

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.

NES operates as a facility of Nasdaq that provides outbound routing from Nasdaq to other market centers, subject to certain conditions.<sup>14</sup> NES's operation as a facility providing outbound routing services for Nasdaq is subject to the conditions that: (1) NES is operated and regulated as a facility of Nasdaq; (2) NES only provides outbound routing services unless otherwise approved by the Commission; (3) the designated examining authority of NES is a self-regulatory organization unaffiliated with Nasdaq; and (4) the use of NES for outbound routing is available only to Nasdaq members and the use of NES remains optional.<sup>15</sup>

The operation of NES as a facility of Nasdaq providing outbound routing services from that exchange will be subject to Nasdaq oversight, as well as Commission oversight. Nasdaq will be responsible for ensuring that NES's outbound routing function is operated consistent with Section 6 of the Act and Nasdaq rules. In addition, Nasdaq must file with the Commission rule changes and fees relating to NES's outbound routing function.

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 of which it is a member, the Exchange previously proposed, and the Commission approved, limitations and conditions on NES's affiliation with the

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<sup>14</sup> See Nasdaq Rule 4758. See also Notice, supra note 3, 76 FR at 8301, n.5.

<sup>15</sup> Id. See also BSE Inbound Routing Order, supra note 9, 73 FR at 80475.

Exchange.<sup>16</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 proposed, and the Commission approved,<sup>17</sup> NES's affiliation with the Exchange to permit the Exchange to accept inbound orders that NES routes in its capacity as a facility of Nasdaq, subject to the following limitations and conditions, which the Exchange states it has met:<sup>18</sup>

- First, the Exchange and FINRA will enter into a Regulatory Contract, as well as an agreement pursuant to Rule 17d-2 under the Act (“17d-2 Agreement”).<sup>19</sup> Pursuant to the Regulatory Contract and the 17d-2 Agreement, FINRA will be allocated regulatory responsibilities to review NES’s compliance with certain Exchange rules.<sup>20</sup> Pursuant to the Regulatory Contract, however, BX retains ultimate responsibility for enforcing its rules with respect to NES.
- Second, FINRA will monitor NES for compliance with the Exchange’s trading rules, and will collect and maintain certain related information.<sup>21</sup>

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<sup>16</sup> See BSE Approval Order, supra note 5, 73 FR at 46944.

<sup>17</sup> See BSE Inbound Routing Order, supra note 9, 73 FR at 80475.

<sup>18</sup> See Notice, supra note 3, 73 FR at 8391-8392.

<sup>19</sup> 17 CFR 240.17d-2.

<sup>20</sup> The Exchange also states that NES is subject to independent oversight by FINRA, its Designated Examining Authority, for compliance with financial responsibility requirements. See Notice, supra note 3, 76 FR at 8391, n.9.

<sup>21</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 its capacity as a facility of Nasdaq 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

- 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 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 Exchange rules.<sup>22</sup>
- Fourth, the Exchange has adopted BX Equity Rule 2140(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.<sup>23</sup>
- Fifth, routing of orders from NES to the Exchange, in NES’s capacity as a facility of Nasdaq, was authorized for a pilot period of twelve months.<sup>24</sup>

The Exchange believes that by meeting the above-listed conditions it has set up

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the Commission’s Office of Compliance Inspections and Examinations. See Notice, supra note 3, 76 FR at 8391, n.10

<sup>22</sup> See Notice, supra note 3, 76 FR at 8392.

<sup>23</sup> See BX Equity Rule 2140(c). See also Notice, supra note 3, 76 FR at 8392.

<sup>24</sup> See Notice, supra note 3, 76 FR at 8392. The Commission notes that the original pilot period of twelve months was approved and began on December 23, 2008, but was extended several times. See Notice, supra note 3, 76 FR at 8391, n.6 and accompanying text.

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>25</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 advantage.<sup>26</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 to provide inbound routing to the Exchange on a permanent basis instead of a pilot basis, subject to the other conditions described above.

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

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<sup>25</sup> See Notice, supra note 3, 76 FR at 8392.

<sup>26</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 8, 2008) (SR-Amex-2008-62) (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 DirectEdge Holdings LLC); and 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.).

advantage. In particular, the Commission believes that FINRA's oversight of NES,<sup>27</sup> combined with FINRA's monitoring of NES's compliance with the equity trading rules and quarterly reporting to the Exchange's CRO, will help to protect the independence of the Exchange's regulatory responsibilities with respect to NES. The Commission also believes that BX Equity Rule 2140(c) 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>28</sup> that the proposed rule change (SR-BX-2011-007) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>29</sup>

Cathy H. Ahn  
Deputy Secretary

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<sup>27</sup> This oversight will be accomplished through the 17d-2 Agreement between FINRA and the Exchange and the Regulatory Contract.

<sup>28</sup> 15 U.S.C. 78s(b)(2).

<sup>29</sup> 17 CFR 200.30-3(a)(12).