

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-64097; File No. SR-BX-2010-079)

March 18, 2011

Self-Regulatory Organizations; NASDAQ OMX BX, Inc.; Order Approving Proposed Rule Change to Amend Chapter IV of the BOX Rules to Allow Executing Participants to Provide BOX a List of the Order Flow Providers for which the Executing Participants will provide Directed Order Services

I. Introduction

On December 3, 2010, NASDAQ OMX BX, Inc. (the “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 proposal to amend the rules governing its Directed Order process to: (i) allow an Executing Participant (“EP”) to provide BOX a list of the Order Flow Providers (“OFPs”) for which the EP will provide Directed Order services and (ii) provide that BOX would reveal to the EP the participant ID of the OFP sending the Directed Order.³ The proposed rule change was published for comment in the Federal Register on December 20, 2010.⁴ The Commission received no comments on the proposal. This order approves the proposal.

II. Description of the Proposal

Under the BOX’s Directed Order process, Market Makers on BOX are able to handle orders on an agency basis directed to them by OFPs. An OFP sends a Directed

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Shortly after the filing of the proposed rule change, the Exchange withdrew an earlier proposal relating to the non-anonymity of Directed Orders (SR-BSE-2005-52). See Securities Exchange Act Release No. 53357 (February 23, 2006), 71 FR 10730 (March 2, 2006) (SR-BSE-2005-52).

⁴ See Securities Exchange Act Release No. 63539 (December 14, 2010), 75 FR 79429 (“Notice”).

Order to BOX with a designation of the Market Maker to whom the order is to be directed. BOX then routes the Directed Order to the appropriate Market Maker. Under Chapter VI, Section 5(c)(ii) of the BOX Rules, a Market Maker only has two choices when receiving a Directed Order: (1) submit the order to the Price Improvement Period auction process (“PIP”);⁵ or (2) send the order back to BOX for placement onto the BOX Book.

A Market Maker who desires to accept Directed Orders must systemically indicate that it is an EP whenever the Market Maker wishes to receive Directed Orders from the BOX Trading Host. If a Market Maker does not systemically indicate that it is an EP, then the BOX Trading Host will not forward any Directed Orders to that Market Maker. In such a case, the BOX Trading Host will send the order directly to the BOX Book. If a Market Maker has systemically indicated that it wishes to receive Directed Orders, it shall not, under any circumstances, reject the receipt of a Directed Order from the BOX Trading Host nor reject the Directed Order back to the OFP who sent it.⁶

The Exchange proposes to amend Chapter VI, Section 5(c)(i) of the BOX Rules to allow EPs to provide BOX a list of OFPs for which the EP will provide Directed Order services. Under the proposal, prior to accepting any Directed Order through the Trading Host, an EP must inform BOX of the OFPs from whom it has agreed to accept Directed Orders (“Listed OFPs” or “LOFPs”). The Trading Host will then only send to the EP

⁵ See Chapter V, Section 18 of the BOX Rules.

⁶ See Chapter VI, Section 5(c)(i) of the BOX Rules.

Directed Orders from LOFPs. Further, under the proposal, the BOX Trading Host would reveal to the EP the participant ID of the OFP sending the Directed Order.⁷

III. Discussion

After careful review of the proposal, 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 exchange⁸ and, in particular, the requirements of Section 6 of the Act.⁹ Specifically, as discussed below, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹⁰ 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; and are not designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

⁷ Pursuant to an existing pilot program, Directed Orders are not anonymous. See e.g., Securities Exchange Act Release Nos. 63540 (December 14, 2010), 75 FR 79432 (December 20, 2010) (continuing the practice of non-anonymous Directed Orders, originally established in SR-BSE-2006-14, as a pilot program until December 31, 2010 (“Directed Order Pilot Program”)) and 63591 (December 21, 2010), 75 FR 81687 (December 28, 2010) (extending the date of the Directed Order Pilot Program until June 30, 2011). The proposed rule change would make permanent this feature of the Directed Order process.

⁸ In approving the proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁹ 15 U.S.C. 78f.

¹⁰ 15 U.S.C. 78f(b)(5).

Section 6(b)(5) of the Act prohibits an exchange from establishing rules that treat market participants in an unfairly discriminatory manner. Section 6(b)(5) of the Act does not prohibit exchange members or other broker-dealers from discriminating, so long as their activities are otherwise consistent with the federal securities laws. Nor does Section 6(b)(5) of the Act require exchanges to preclude discrimination by broker-dealers. Broker-dealers commonly differentiate between customers based on the nature and profitability of their business.

Currently under BOX's rules, an Options Participant that is not a Market Maker may provide an opportunity for price improvement to a customer order by submitting it to the PIP. An Options Participant may decide who to accept as its customers and further choose to provide price improvement to some customer orders, but not others, by exercising discretion as to whether it chooses to send a particular order to the PIP auction.¹¹ An Options Participant would know the identity of its customer in deciding whether to provide this opportunity for price improvement. Market Makers may also provide an opportunity for price improvement to Directed Orders by submitting them into the PIP. The proposed rule change, by permitting a Market Maker to designate those OFPs from which it will accept Directed Orders and to be provided with the identity of the OFP sending a Directed Order, would allow a Market Maker to decide in advance that it will provide an opportunity for price improvement only to orders from certain OFPs.¹²

¹¹ See also Rule 723 of the International Securities Exchange, LLC (Price Improvement Mechanism) and Rule 6.74A of the Chicago Board Options Exchange, Incorporated (Automated Improvement Mechanism).

¹² Specialists and other market makers may establish payment for order flow relationships with firms on a discretionary basis. A specialist or market maker may pay varying amounts for order flow received from different firms or different customers within firms. Unlike payment for order flow, which principally

Thus, the proposal will provide information to Market Makers that are EPs that is the same information available to other BOX members when they decide whether to provide price improvement to a particular order.

While customer anonymity may be valuable in ensuring that broker-dealers comply with legal obligations in a variety of circumstances, such as market makers' firm quote obligations, customer anonymity is not required of exchanges, particularly when disclosure of customer identity could provide benefits to certain customers beyond those required by the federal securities laws or exchange rules. In particular, market makers may be willing to offer better execution prices to certain customers' orders (e.g., retail customers' orders). The Commission does not believe that it would be inconsistent with the federal securities laws for the Exchange to provide, under the circumstances set forth in this proposal, the means for its Market Makers to differentiate between customers in providing price improvement or other non-required advantages to certain customers. The Exchange's proposal treats all Market Makers the same and establishes no requirements for which OFPs a Market Maker designates as LOFPs or for which orders a Market Maker chooses to provide an opportunity for price improvement. The Commission does not believe that the absence of Exchange rules specifying which orders a Market Maker may execute at prices better than its public quote is unfairly discriminatory.

The Commission notes that allowing a Market Maker to know the identity of firms sending Directed Orders may provide further incentive to that Market Maker to provide price improvement. A Market Maker that receives a Directed Order would be

benefits intermediaries and, indirectly, their customers through possibly lower fees and better services, customers' orders executed through the PIP auction directly benefit customers with the opportunity for an improved price.

required to decide whether to send the order to the PIP and guarantee a price equal to or better than the NBBO to such order, or to release the order to the BOX book. The Market Maker's decision about whether to choose to guarantee a particular order at a price equal to or better than the NBBO may be affected by this proposal because it provides Market Makers with information to differentiate between orders from informed traders (i.e., their competitors) and orders from uninformed traders. It is well known in academic literature and industry practice that prices tend to move against market makers after trades with informed traders, often resulting in losses for market makers.¹³ Thus, there is a strong economic rationale for market makers not providing informed traders price improvement. Uninformed investors end up bearing the cost of these market maker losses through wider spreads that market makers need to quote to uninformed investors due to informed order flow.¹⁴

Accordingly, while the Exchange's proposal would permit a BOX Market Maker to discriminate among customers in providing prices better than its quote, the Commission does not believe that this discrimination is inconsistent with Section 6(b)(5) of the Act.

The Commission continues to believe that under the proposal, a Market Maker would maintain the incentive to quote aggressively to gain priority with respect to orders entered on the BOX book. Further, the Commission believes that there is rigorous

¹³ See Stoll, H. R., "The supply of dealer services in securities of markets," Journal of Finance 33 (1978), at 1133-51; Glosten, L. and P. Milgrom, "Bid ask and transaction prices in a specialist market with heterogeneously informed agents," Journal of Financial Economics 14 (1985), at 71-100; and Copeland, T., and D. Galai, "Information effects on the bid-ask spread," Journal of Finance 38 (1983), at 1457-69.

¹⁴ Id.

competition for order flow across options exchanges, such that any widening of quotes on one market is an opportunity for another option market to capture order flow.¹⁵ In fact, the Options Order Protection and Locked/Crossed Market Plan provides protection from one exchange ignoring better quoted prices on another market and will continue to promote quote competition across options exchanges.¹⁶

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular with Section 6(b)(5) of the Act.¹⁷

¹⁵ See Robert Battalio, “Third Market Broker-Dealers: Cost Competitors or Cream Skimmers?” Journal of Finance, 1997; and Robert Battalio, Robert Jason Greene, and Robert Jennings, “How do Competing Specialists and Preferencing Dealers Affect Market Quality?” Review of Financial Studies, 1997.

¹⁶ See Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009).

¹⁷ 15 U.S.C. 78f(b)(5).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁸ that the proposed rule change (File No. SR-BX-2010-079) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁹

Cathy H. Ahn
Deputy Secretary

¹⁸ 15 U.S.C. 78s(b)(2).

¹⁹ 17 CFR 200.30-3(a)(12).