

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-77235; File No. SR-NASDAQ-2015-159)

February 25, 2016

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Approving a Proposed Rule Change to Implement Additional Price Protections in the Opening Process

I. Introduction

On December 23, 2015, 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”)¹ and Rule 19b-4 thereunder,² a proposed rule change to enhance the price protections for the Exchange’s opening process. The proposed rule change was published for comment in the Federal Register on January 11, 2016.³ The Commission received one comment letter on the proposed rule change.⁴ This order approves the proposed rule change.

II. Description of the Proposal

The Exchange proposes new paragraph (F) to Rule 4752(d)(2) to enhance the price protections for the Nasdaq Opening Cross.⁵

Background

Nasdaq Rule 4752(d) describes the Nasdaq Opening Cross process, and Rule 4752(d)(2)(A) through (E) sets forth the process for determining the price at which an Opening

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 76833 (January 5, 2016), 81 FR 1240 (“Notice”).

⁴ See letter from Kermit Kubitz to the Commission, dated February 1, 2016 (“Kubitz Letter”).

⁵ The term “Nasdaq Opening Cross” (hereinafter also referred to as “Opening Cross”) is defined in Nasdaq Rule 4752(a)(5).

Cross occurs. Specifically, the Opening Cross occurs at 9:30 a.m. ET and occurs at the price that maximizes the number of shares of Market On Open orders (“MOO”), Limit On Open orders (“LOO”), Opening Imbalance Only orders (“OIO”), Early Market Hours orders, and executable quotes and orders in the Nasdaq Market Center to be executed.⁶ If more than one price exists that would maximize such quotes and orders to be executed, then the Opening Cross occurs at the price that minimizes any imbalance.⁷ If more than one price exists that would minimize an imbalance, then the Opening Cross occurs at the entered price at which shares will remain unexecuted in the cross.⁸ If more than one price exists at which shares will remain unexecuted in the cross, then the Opening Cross occurs at the price that minimizes the distance from the bid-ask midpoint of the inside quotation prevailing at 9:30 a.m.⁹

In addition to the calculation of the Opening Cross price pursuant to Rule 4752(d)(2)(A) through (D), the Exchange applies a price range within which the Opening Cross must execute in order to ensure that the Opening Cross price is reasonably tied to the prevailing market at the time.¹⁰ Specifically, the Exchange applies a percentage based threshold (“Threshold Percentage”) to a benchmark (“Benchmark Value”) to determine a specific value.¹¹ That value is then applied to the spread for a particular security to determine the price range within which the Opening Cross for the security may occur (“Threshold Range”), and outside of which the

⁶ See Notice, 81 FR at 1241; see also Rule 4752(d)(2)(A). The MOO, LOO, and OIO order types are defined in Rules 4702(b)(8), (b)(9), and (b)(10), respectively; the Early Market Hours order type is defined in Rule 4752(a)(7).

⁷ See Notice, 81 FR at 1241; see also Rule 4752(d)(2)(B).

⁸ See Notice, 81 FR at 1241; see also Rule 4752(d)(2)(C).

⁹ See Notice, 81 FR at 1241; see also Rule 4752(d)(2)(D).

¹⁰ See Notice, 81 FR at 1241; see also Rule 4752(d)(2)(E).

¹¹ See Notice, 81 FR at 1241; see also Rule 4752(d)(2)(E).

Opening Cross for the security may not occur.¹² Currently, the Threshold Percentage is 10% and the Benchmark Value is the midpoint of the Nasdaq Best Bid and Offer (“QBBO”).¹³ To establish the Threshold Range, the Exchange calculates 10% of the midpoint of the QBBO, and then adds the resulting value to the Nasdaq Best Offer and subtracts the resulting value from the Nasdaq Best Bid.¹⁴ If the Opening Cross price of a security established pursuant to Rule 4752(d)(2)(A) through (D) falls outside the Threshold Range, then the Exchange adjusts the Opening Cross price to a price within the Threshold Range that best satisfies the conditions of Rule 4752(d)(2)(A) through (D).¹⁵

According to the Exchange, the current price adjustment process has been effective at ensuring that the Opening Cross price of a security falls within a certain range of the QBBO.¹⁶ However, an order or quote entered by a participant in error that establishes one side of the QBBO could result in an excessively wide QBBO and significantly skew the Opening Cross price of a security.¹⁷ The current price adjustment process would not prevent the Opening Cross from occurring at an erroneous price under these circumstances, because the price would still fall within the excessively wide Threshold Range, which would be calculated using the excessively

¹² See Notice, 81 FR at 1241; see also Rule 4752(d)(2)(E).

¹³ See Notice, 81 FR at 1241. The Threshold Percentage and Benchmark Value are set by Nasdaq officials in advance and are published via the NasdaqTrader website. See id.

¹⁴ See id.

¹⁵ See id.; see also Rule 4752(d)(2)(E).

¹⁶ See Notice, 81 FR at 1242.

¹⁷ See id. The Commission understands that such a scenario is most likely to arise with illiquid securities.

wide QBBO.¹⁸ Under these circumstances, the parties to the erroneously priced transactions would have to avail themselves of the Exchange’s clearly erroneous trade nullification process.¹⁹

New Price Protections

In order to mitigate the potential for mispriced Opening Crosses and the resulting need to use the Exchange’s clearly erroneous trade nullification process, the Exchange proposes additional price protections for its opening process to help ensure that the Opening Cross price is reasonably related to the market and not the product of erroneous order entry.²⁰ Specifically, in addition to the existing process for determining the Opening Cross price for a security, the Exchange would require the security to pass one of three new “Opening Cross Price Tests” in order for an Opening Cross in the security to occur.²¹ Each Opening Cross Price Test would specify a range within which the Opening Cross price must fall and, as discussed in more detail below, each price range is calculated by applying a threshold to a specific reference measure.²² The Exchange proposes to initially set the threshold for each Opening Cross Price Test at the greater of \$0.50 or 10% of the reference measure, although the Exchange may adjust the thresholds for each Opening Cross Price Test independently of one another.²³ If a security’s Opening Cross price fails all three tests, then all MOO, LOO, OIO, and Early Market Hours orders in the Nasdaq Opening Cross in that security would be cancelled back to the participants,

¹⁸ See id.

¹⁹ See id.

²⁰ See id.

²¹ See id.; see also proposed Rule 4752(d)(2)(F).

²² See Notice, 81 FR at 1242; see also proposed Rule 4752(d)(2)(F).

²³ See Notice, 81 FR at 1242. As proposed, Nasdaq management would set and modify the thresholds from time to time upon prior notice to market participants. See id.; see also proposed Rule 4752(d)(2)(F). In addition, the Exchange states that the thresholds for the proposed Opening Cross Price Tests would be published via the NasdaqTrader website. See Notice, 81 FR at 1242.

no Opening Cross would occur in that security, and the security would open for regular market hours trading consistent with Rule 4752(c).²⁴

Under Opening Cross Price Test A, for a Nasdaq-listed security, the Exchange would establish the Opening Cross price range by adding the threshold amount to and subtracting the threshold amount from the Nasdaq Official Closing Price of the security from the previous trading day. For non-Nasdaq-listed securities, the Exchange would establish the price range by adding the threshold amount to and subtracting the threshold amount from the consolidated closing price of the security from the previous trading day. For new Exchange Traded Products (“ETPs”) that do not have a Nasdaq Official Closing Price, the Exchange would establish the price range by adding the threshold amount to and subtracting the threshold amount from the offering price. If the Opening Cross price falls outside of the relevant price range, or if a security does not have a Nasdaq Official Closing Price or consolidated closing price from the previous trading day, then the security would fail Opening Cross Price Test A and the Exchange would perform Opening Cross Price Test B.²⁵

Under Opening Cross Price Test B, the Exchange would establish the Opening Cross price range by adding the threshold amount to and subtracting the threshold amount from the Nasdaq last sale (either round lot or odd lot) after 9:15 a.m. ET but before the Opening Cross. If the Opening Cross price falls outside this price range, or if there is no Nasdaq last sale, then the security would fail Opening Cross Price Test B and the Exchange would perform Opening Cross Price Test C.²⁶

²⁴ See Notice, 81 FR at 1242; see also proposed Rule 4752(d)(2)(F).

²⁵ See Notice, 81 FR at 1242; see also proposed Rule 4752(d)(2)(F)(i).

²⁶ See Notice, 81 FR at 1242; see also proposed Rule 4752(d)(2)(F)(ii).

Under Opening Cross Price Test C, if the Opening Cross price is higher than the closing price used under Test A, then the Exchange would establish the price range by adding the threshold amount to and subtracting the threshold amount from the Nasdaq Best Bid. If the Opening Cross price is lower than the closing price used under Test A, then the Exchange would establish the price range by adding the threshold amount to and subtracting the threshold amount from the Nasdaq Best Offer. If a security does not have a Nasdaq Official Closing Price or consolidated closing price, as applicable, then the Exchange would use a price of \$0. If the Opening Cross price for a security falls outside of the relevant price range, then no Opening Cross would occur in the security; MOO, LOO, OIO, and Early Market Hours orders would be cancelled; and the Exchange would open that security for market hours trading consistent with Rule 4752(c).²⁷

Implementation

The Exchange proposes to implement the Opening Cross Price Tests in stages over the course of approximately four weeks, beginning with a small number of securities.²⁸ The Exchange states that the implementation details would be published via an Exchange Trader Alert and be posted on the NasdaqTrader website.²⁹

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.³⁰ In particular, the Commission finds that the proposed rule change is

²⁷ See Notice, 81 FR at 1242; see also proposed Rule 4752(d)(2)(F)(iii).

²⁸ See Notice, 81 FR at 1243.

²⁹ See id.

³⁰ In approving this proposed rule change, the Commission has considered the proposed

consistent with Section 6(b)(5) of the Act,³¹ 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 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 notes that the proposal is designed to enhance the price protections for the Exchange's opening process, to mitigate the potential for mispriced trades, and to mitigate the need to use the Exchange's clearly erroneous trade nullification process. In particular, as discussed above, the proposed Opening Cross Price Tests are designed to mitigate the potential for a mispriced Opening Cross when an order or quote entered by a participant in error establishes one side of the QBBO and significantly skews the Opening Cross price for the security. As noted by the Exchange, the proposal would help ensure that the Opening Cross price for a security is reasonably related to the market and not the product of erroneous order entry. The Commission also notes that a commenter expressed support for the proposal, stating that the "proposed change to avoid a biased or erroneous opening due to an inadvertent or mistaken submission of a pre-open order and price is a reasonable change by NASDAQ."³² Based on the foregoing, the Commission believes that the proposed Opening Cross Price Tests are consistent with the Act.

rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

³¹ 15 U.S.C. 78f(b)(5).

³² See Kubitiz Letter, supra note 4. This commenter also expressed broader concerns regarding the availability of information about pre-market activities and regarding the circumstances under which pre-market activities would constitute manipulation, in light of the events of August 24, 2015. See id.

The Commission also believes that the Exchange's proposal to implement the Opening Cross Price Tests in stages is consistent with the Act because it would help to limit potential market disruption if the Exchange experiences a technical issue with the implementation.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³³ that the proposed rule change (SR-NASDAQ-2015-159) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁴

Robert W. Errett
Deputy Secretary

³³ 15 U.S.C. 78s(b)(2).

³⁴ 17 CFR 200.30-3(a)(12).