

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-68303; File No. SR-BYX-2012-019)

November 27, 2012

Self-Regulatory Organizations; BATS Y-Exchange, Inc.; Order Granting Approval to Proposed Rule Change, as Modified by Amendment No. 2, to Adopt a Retail Price Improvement Program

I. Introduction

On August 14, 2012, BATS Y-Exchange, Inc. (the “Exchange” or “BYX”) 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 to establish a Retail Price Improvement Program (“Program”) on a pilot basis for a period of one year from the date of implementation, if approved. The proposed rule change was published for comment in the Federal Register on August 31, 2012.<sup>3</sup> The Commission received one comment on the BYX proposal.<sup>4</sup> On October 12, 2012, the Commission extended the time for Commission action on the proposed rule change until November 29, 2012.<sup>5</sup> The Exchange submitted a response letter on November 13, 2012.<sup>6</sup> On October 4, 2012, the Exchange filed

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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. 67734 (August 27, 2012), 77 FR 53242 (SR-BYX-2012-019) (“Notice”).

<sup>4</sup> See Letter from Theodore R. Lazo, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, Commission, dated September 26, 2012 (“SIFMA Letter”).

<sup>5</sup> See Securities Exchange Act Release No. 68049, 77 FR 64180 (October 18, 2012).

<sup>6</sup> See Letter from Eric Swanson, Senior Vice President and General Counsel, BATS Global Markets, to Elizabeth M. Murphy, Secretary, Commission, dated November 13, 2012 (“Exchange Response to Comments”).

Amendment No. 1 to its proposal.<sup>7</sup> On November 13, 2012, the Exchange filed Amendment No. 2 to its proposal.<sup>8</sup>

In connection with the proposal, the Exchange requested exemptive relief from Rule 612 of Regulation NMS,<sup>9</sup> which, among other things, prohibits a national securities exchange from accepting or ranking orders priced greater than \$1.00 per share in an increment smaller than \$0.01.<sup>10</sup> On November 19, 2012, the Exchange submitted a letter requesting that the staff of the Division of Trading and Markets not recommend any enforcement action under Rule 602 of Regulation NMS (“Quote Rule”) based on the Exchange’s and its members’ participation in the Program (“No-Action Request Letter”).<sup>11</sup>

This order approves the proposed rule change, as modified by Amendment No. 2, and grants the exemption from the Sub-Penny Rule sought by the Exchange in relation to the proposed rule change.

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<sup>7</sup> The Exchange withdrew Amendment No. 1 on October 4, 2012.

<sup>8</sup> In Amendment No. 2, the Exchange proposes to delete a statement explaining that a Retail Liquidity Identifier for Tape C securities would not be published until after October 1, 2012. The Exchange is deleting this statement because the processor is currently able to disseminate the identifier. The Exchange also proposes to clarify that the securities will be phased into the Program, and modify its statutory basis discussion to support this change. Finally, the Exchange proposes to modify the Rule Text to state that the Exchange will notify its membership regarding the securities included in the Program through an information circular (“Amendment No. 2”). Because the changes made in Amendment No. 2 do not materially alter the substance of the proposed rule change or raise any novel regulatory issues, Amendment No. 2 is not subject to notice and comment.

<sup>9</sup> 17 CFR 242.612 (“Sub-Penny Rule”).

<sup>10</sup> See Letter from Eric Swanson, Senior Vice President and General Counsel, BATS Global Markets, to Elizabeth M. Murphy, Secretary, Commission, dated August 14, 2012 (“Request for Sub-Penny Rule Exemption”).

<sup>11</sup> See Letter from Eric J. Swanson, Senior Vice President and General Counsel, BATS Global Markets, to Robert Cook, Division of Trading and Markets, Commission, dated November 19, 2012 (“No-Action Letter”).

## II. Description of the Proposal

The Exchange is proposing a one-year pilot program to attract additional retail order flow to the Exchange, while also providing the potential for price improvement to such order flow. The Program would be limited to trades occurring at prices equal to or greater than \$1.00 per share.

All securities traded on the Exchange would be eligible for inclusion in the Program. As proposed in Amendment No. 2, for the first 90 days of the pilot program, a group of up to 25 securities would participant in the program. These securities would represent those securities traded most heavily by retail investors. After the initial 90 day period, the Program will be expanded gradually until all securities traded on the Exchange are included. The Exchange will notify Members in an information circular of the securities that are subject to the Program both initially and as additional securities become eligible for inclusion.<sup>12</sup>

Under the Program, a new class of market participants called Retail Member Organizations (“RMOs”)<sup>13</sup> would be eligible to submit certain retail order flow (“Retail Orders”) to the Exchange. All Exchange Users<sup>14</sup> would be permitted to provide potential price improvement for Retail Orders in the form of non-displayed interest that is better than the national best bid that is a Protected Quotation (“Protected NBB”) or the national best offer that is a Protected Quotation (“Protected NBO,” and together with the Protected NBB, the “Protected

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<sup>12</sup> See Amendment No. 2, *supra* note 8.

<sup>13</sup> A RMO would be a Member (or a division thereof) that has been approved by the Exchange to submit Retail Orders. A “Member” is any registered broker or dealer that has been admitted to membership in the Exchange. See BYX Rule 1.5(n).

<sup>14</sup> A “User” is any Member or sponsored participant of the Exchange who is authorized to obtain access to the System. See BYX Rule 1.5(cc).

NBBO”)<sup>15</sup> called a Retail Price Improvement Order (“RPI Order”). When an RPI Order priced at least \$0.001 better than the Protected Bid or Protected Offer for a particular security is available in the System, the Exchange would disseminate an identifier, known as the Retail Liquidity Identifier, indicating that such interest exists. A Retail Order would interact, to the extent possible, with available contra-side RPI Orders.<sup>16</sup>

The Exchange represents that its proposed rule change is based on New York Stock Exchange LLC’s (“NYSE”) Rule 107C, which governs NYSE’s previously approved Retail Liquidity Program,<sup>17</sup> with three distinctions. First, the NYSE’s Retail Liquidity Program creates a category of members, Retail Liquidity Providers, who are required to maintain an RPI that betters the protected best bid or offer at least 5% of the trading day in each assigned security. Under the BYX’s proposal, the Exchange would not create such a category of users. Second,

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<sup>15</sup> The term Protected Quotation has the same meaning as defined in Rule 600(b)(58) of Regulation NMS. See BYX Rule 1.5(t). Rule 600(b)(58) of Regulation NMS defines “protected quotation” as “a protected bid or a protected offer.” 17 CFR 242.600(b)(58). The Protected NBB is the best-priced protected bid and the Protected NBO is the best-priced protected offer. See BYX Rule 1.5(s). The Exchange represents that, generally, the Protected NBB and Protected NBO, and the national best bid (“NBB”) and national best offer (“NBO,” together with the NBB, the “NBBO”), will be the same. However, it further represents that a market center is not required to route to the NBB or NBO if that market center is subject to an exception under Regulation NMS Rule 611(b)(1) or if such NBB or NBO is otherwise not available for an automatic execution. In such case, the Exchange states that the Protected NBB or Protected NBO would be the best-priced protected bid or offer to which a market center must route interest pursuant to Rule 611 of Regulation NMS.

<sup>16</sup> As explained further below, the Exchange has proposed two types of Retail Orders, one of which could execute against other interest if it was not completely filled by contra-side RPI Interest or other price-improving liquidity. All Retail Orders would first execute against available contra-side RPI Orders or other price-improving liquidity. Any remaining portion of the Retail Order would then either cancel, be executed as an immediate-or-cancel order, or be routed to another market for execution, depending on the type of Retail Order.

<sup>17</sup> See Securities Exchange Act Release No. 67347 (July 3, 2012), 77 FR 40673 (July 10, 2012) (SR-NYSE-2011-55; SR-NYSEAmex-2011-84) (“RLP Approval Order”). In the RLP Approval Order, the Commission also approved a Retail Liquidity Program for NYSE Amex LLC (now known as NYSE MKT LLC) (“NYSE MKT”).

NYSE's Retail Liquidity Program does not permit the execution of Retail Orders against other resting non-displayed liquidity. BYX's proposal would permit such executions. Finally, under the NYSE'S Retail Liquidity Program, Retail Orders execute at the single price at which the order will be fully executed. Pursuant to the BYX's proposal, Retail Orders execute at multiple price levels rather than a single price level.<sup>18</sup>

#### Types of Orders and Identifier

A Retail Order would be an agency order that originates from a natural person and is submitted to the Exchange by a RMO, 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. Users and RMOs could enter odd lots, round lots, or mixed lots as RPI Orders and as Retail Orders, respectively.

A RPI Order would be non-displayed interest on the Exchange that is better than the Protected NBB or Protected NBO by at least \$0.001 and that is identified as a RPI Order in a manner prescribed by the Exchange. An RPI Order may also be entered in a sub-penny increment with an explicit limit price. When such an order is available in the System in a particular security, the Exchange would disseminate an identifier, known as the Retail Liquidity Identifier, indicating that such interest exists. The Exchange would implement the Program in a manner that allowed the dissemination of the identifier through consolidated data streams (i.e., pursuant to the Consolidated Tape Association Plan/Consolidated Quotation Plan ("CTA/CQ Plan") for Tape A and Tape B securities, and the Nasdaq UTP Plan for Tape C securities as well as through proprietary Exchange data feeds. The Retail Liquidity Identifier would reflect the symbol and the side (buy or sell) of the RPI Order, but it would not include the price or size. In particular, CQ and UTP quoting outputs would include a field for codes related to the Retail

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<sup>18</sup> See Notice, supra note 3, 77 FR at 53245-46 (explaining the three distinctions in detail).

Liquidity Identifier. The codes will indicate RPI Orders that are priced better than the Protected Bid or Protected Offer by at least the minimum level of price improvement as required by the Program.

#### Retail Member Organizations

In order to become a RMO, a Member must conduct a retail business or handle retail orders on behalf of another broker-dealer. Any Member that wishes to obtain RMO status would be required to submit: (1) an application form; (2) an attestation, in a form prescribed by the Exchange, that any order submitted by the Member as a Retail Order would meet the qualifications for such orders; and (3) supporting documentation sufficient to demonstrate the retail nature and characteristics of the applicant's order flow.<sup>19</sup> If the Exchange disapproves the application, it would provide a written notice to the Member. The disapproved applicant could appeal the disapproval as provided below and/or re-apply 90 days after the disapproval notice is issued by the Exchange. An RMO also could voluntarily withdraw from such status at any time by giving written notice to the Exchange.

The Exchange would require a RMO to have written policies and procedures reasonably designed to assure that it will only designate orders as Retail Orders if all the requirements of a Retail Order are met. Such written policies and procedures would have to require the Member to exercise due diligence before entering a Retail Order to assure that entry as a Retail Order is in compliance with the proposed rule, and monitor whether orders entered as Retail Orders meet the applicable requirements. If the RMO represents Retail Orders from another broker-dealer customer, the RMO's supervisory procedures must be reasonably designed to assure that the

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<sup>19</sup> For example, a prospective RMO could be required to provide sample marketing literature, website screenshots, other publicly disclosed materials describing the retail nature of their order flow, and such other documentation and information as the Exchange may require to obtain reasonable assurance that the applicant's order flow would meet the requirements of the Retail Order definition.

orders it receives from such broker-dealer customer that it designates as Retail Orders meet the definition of a Retail Order. The RMO must obtain an annual written representation, in a form acceptable to the Exchange, from each broker-dealer customer that sends it orders to be designated as Retail Orders that entry of such orders as Retail Orders will be in compliance with the requirements of this rule, and monitor whether its broker-dealer customer's Retail Order flow continues to meet the applicable requirements.<sup>20</sup>

#### Retail Order Designations

Under the proposal, a RMO submitting a Retail Order could choose one of two designations dictating how it would interact with available contra-side interest. First, a Retail Order could interact only with available contra-side RPI Orders and other price-improving liquidity. The Exchange would label this a Type 1 Retail Order and such orders would not interact with available non-price-improving, contra-side interest in Exchange systems or route to other markets. Portions of a Type 1 Retail Order that are not executed would be cancelled immediately and automatically.

Second, a Retail Order could interact first with available contra-side RPI Orders and other price-improving liquidity, and any remaining portion would be eligible to interact with other interest in the System<sup>21</sup> and, if designated as eligible for routing, would route to other markets in compliance with Regulation NMS.<sup>22</sup> The Exchange would label this a Type 2 Retail

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<sup>20</sup> The Exchange represents that it or another self-regulatory organization on behalf of the Exchange will review a RMO's compliance with these requirements through an exam-based review of the RMO's internal controls. See Notice, supra note 3, 77 FR at 53244 n.9.

<sup>21</sup> The System is "the electronic communications and trading facility designated by the Board through which securities orders of Users are consolidated for ranking, execution and, when applicable, routing away." BYX rule 1.5(aa).

<sup>22</sup> See BYX Rule 11.9(b)(1).

Order, and it could either be submitted as a BATS Only Order<sup>23</sup> or as an order eligible for routing.

#### Priority and Allocation

The Exchange would follow price-time priority, ranking RPI Orders in the same security according to price and then time of entry into the System. Any remaining unexecuted RPI Orders would remain available to interact with other incoming Retail Orders if such interest is at an eligible price. Any remaining unexecuted portion of a Retail Order would cancel or execute in accordance with the proposed rule.<sup>24</sup>

#### Failure of RMO to Abide by Retail Order Requirements

The proposed rule addresses an RMO's failure to abide by Retail Order requirements. If a RMO were to designate orders submitted to the Exchange as Retail Orders and the Exchange determined, in its sole discretion, that those orders failed to meet any of the requirements of Retail Orders, the Exchange could disqualify a Member from its status as a RMO. When disqualification determinations are made, the Exchange would provide a written disqualification notice to the Member. A disqualified RMO could appeal the disqualification as provided below and/or re-apply 90 days after the disqualification notice is issued by the Exchange.

#### Appeal Process

Under the proposal, the Exchange would establish a Retail Price Improvement Program Panel ("RPI Panel") to review disapproval or disqualification decisions. If a Member disputes the Exchange's decision to disapprove or disqualify it as a RMO, such Member could request, within five business days after notice of the decision is issued by the Exchange, that the RPI

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<sup>23</sup> A BATS Only Order is an order that is not eligible for routing to other trading centers. See BYX Rule 11.9(c)(4).

<sup>24</sup> The Exchange provides three examples of how the priority and ranking of RPI Orders would operate. See Notice, supra note 3, 77 FR at 53245.

Panel review the decision to determine if it was correct. The RPI Panel would consist of the Exchange's Chief Regulatory Officer or his or her designee, and two officers of the Exchange designated by the Exchange's Chief Operating Officer, and it would review the facts and render a decision within the timeframe prescribed by the Exchange. The RPI Panel could overturn or modify an action taken by the Exchange and all determinations by the RPI Panel would constitute final action by the Exchange on the matter at issue.

### III. Comment Letters and the Exchange's Responses

As noted above, the Commission received one comment letter that raised concerns about the BYX proposal.<sup>25</sup> The main areas of concern expressed therein were: (1) whether the proposal impedes fair access; (2) the proposal's impact on the Sub-Penny Rule; and (3) the dissemination of quotations.<sup>26</sup>

The commenter argued that the BYX's proposal would result in a two-tiered market wherein market participants could only access available interest identified by the Retail Liquidity Identifier if they were seeking to interact with an order placed by a retail customer. The commenter believes that this is inconsistent with the requirements of Section 6(b)(5) of the Exchange Act as it would allow for unfair discrimination against institutional investors. The commenter expressed concern that approval of the NYSE Retail Liquidity Program, coupled

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<sup>25</sup> See note 4, supra.

<sup>26</sup> See SIFMA Letter, p. 3-4. In addition to commenting on the proposal, the commenter suggested that the Commission, rather than the staff by delegated authority, should consider whether to approve or disapprove BYX's proposed rule change because of the important issues it raises. The commenter further stated that the Commission should consider and resolve market structure issues through the formal rulemaking process, as opposed to allowing such issues to be addressed in rule changes. See SIFMA Letter, p. 1-2.

with approval of the BYX proposal, would set a precedent for other exchanges to discriminate among members.<sup>27</sup>

In response, the Exchange explained that it believes that the differential treatment proposed in connection with the Program is not designed to permit unfair discrimination, but instead to promote a competitive process through which retail investors would receive better prices than they currently do in light of bilateral internalization arrangements currently utilized to execute such orders. The Exchange argued the Program is consistent with Section 6(b)(5) of the Exchange Act as it is designed to attract retail order flow to the Exchange and help ensure that retail investors benefit from the better prices that liquidity providers are willing to give such orders.

The commenter also expressed concern that under the BYX proposal, priority would be given based on sub-penny increments, and tick size would be reduced to \$.001 even though Rule 612 of Regulation NMS prohibits national securities exchanges from accepting or ranking certain order based on an increment smaller than the minimum price increment. The commenter noted that quoting in sub-penny increments does not contribute to the maintenance of orderly markets and that it encourages market participants to step ahead of competing limit orders to gain an insignificant price improvement. The commenter suggested that if the Commission has determined that the protections of Rule 612 are no longer necessary, it should address this in a rulemaking, rather than granting individual exchange exemptions.<sup>28</sup>

In response, the Exchange noted that Rule 612 was adopted to address the Commission's concern that sub-penny increments could erode the incentives of investors to display limit orders.

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<sup>27</sup> See SIFMA Letter, p. 3.

<sup>28</sup> See SIFMA Letter, p. 4.

The Exchange argued that its Program would not reduce such incentives. The Exchange explained that market participants currently are not able to interact with retail order flow because it is routinely routed to internalizing OTC market makers that offer sub-penny executions. The Exchange believes that allowing the Exchange to compete for this retail order flow through the Program should not materially detract from current incentives to display limit orders, and could result in greater order interaction and price improvement for market retail orders on the Exchange. Further, the Exchange explained that its Program would not encourage market participants to step ahead of competing limit orders to gain an insignificant price improvement because pursuant to the Program, neither Retail Orders nor RPI Orders will be displayed by the Exchange.

Finally, the commenter argued that the Exchange's Retail Liquidity Identifier that would be disseminated through the consolidated data stream is an indication of interest that is a quotation, and encouraged the Commission to conduct its own analysis of whether these identifiers are quotations. The commenter also questioned whether broker-dealers would be required to consider these identifiers in making routing decisions consistent with their best execution obligations and expressed concern that a proliferation of the use of identifiers such as that proposed by BYX would increase broker-dealers' compliance burdens because they would be required continuously to evaluate these identifiers on multiple exchanges and it could pose obligations under the order protection rule of Regulation NMS.<sup>29</sup>

In response, the Exchange explained that it believes that neither the Program's RPI Orders nor the retail liquidity identifiers meet the definition of a "bid" or "offer" in Rule 600(b)(8) of Regulation NMS, and therefore are not quotations, because they do not communicate a specific price. Because the Exchange does not believe that RPI are quotations

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<sup>29</sup> See SIFMA Letter, p. 4-5.

pursuant to Rule 602, it argues that they are not subject the Rule 611 of Regulation NMS (Order Protection Rule). Finally, the Exchange stated that it believes that a broker-dealer should consider the Program when conducting its best execution analysis, but does not believe that the Program would create any best execution challenges for broker-dealer's that do not already exist in today's market.

#### IV. Discussion and Commission Findings

After careful review of the proposal, the comment letter received, and the Exchange's response, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange. In particular, the Commission finds that the proposed rule change, subject to its term as a pilot, is consistent with Section 6(b)(5) of the Act,<sup>30</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, 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 not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

The Commission finds that the Program, as it is proposed on a pilot basis, is consistent with the Act because it is reasonably designed to benefit retail investors by providing price improvement to retail order flow.<sup>31</sup> The Commission also believes that the Program could

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<sup>30</sup> 15 U.S.C. 78f(b)(5).

<sup>31</sup> The Commission recently approved similar Retail Liquidity Programs for NYSE and NYSE MKT. See RLP Approval Order, supra note 17.

promote competition for retail order flow among execution venues, and that this could benefit retail investors by creating additional price improvement opportunities for their order flow. Currently, most marketable retail order flow is executed in the OTC markets, pursuant to bilateral agreements, without ever reaching a public exchange. The Commission has noted that “a very large percentage of marketable (immediately executable) order flow of individual investors” is executed, or “internalized,” by broker-dealers in the OTC markets.<sup>32</sup> A review of the order flow of eight retail brokers revealed that nearly 100% of their customer market orders were routed to OTC market makers.<sup>33</sup> The same review found that such routing is often done pursuant to arrangements under which retail brokers route their order flow to certain OTC market makers in exchange for payment for such order flow.<sup>34</sup> To the extent that the Program may provide price improvement to retail orders that equals what would be provided under such OTC internalization arrangements, the Program could benefit retail investors. To better understand the Program’s potential impact, the Exchange represents that it “will produce data throughout the pilot, which will include statistics about participation, the frequency and level of price improvement provided by the Program, and any effects on the broader market structure, and would be reviewed by the Commission prior to any extension of the Program beyond the proposed one-year pilot term, or permanent approval of the Program.”<sup>35</sup>

The Program proposes to create additional price improvement opportunities for retail investors by segmenting retail order flow on the Exchange and requiring liquidity providers that want to interact with such retail order flow to do so at a price at least \$0.001 per share better than

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<sup>32</sup> See Securities Exchange Act Release No. 61358 (Jan. 14, 2010), 75 FR 3594, 3600 (Jan. 21, 2010) (“Concept Release on Equity Market Structure”).

<sup>33</sup> See id.

<sup>34</sup> See id.

<sup>35</sup> See Notice, supra note 3, 77 FR at 53245.

the Protected Best Bid or Offer. As noted above, the commenter questioned the fairness of treating retail order flow differently from other order flow on an exchange by offering price improvement opportunities only to retail orders. The Commission finds that, while the Program would treat retail order flow differently from order flow submitted by other market participants, such segmentation would not be inconsistent with Section 6(b)(5) of the Act, which requires that the rules of an exchange are not designed to permit unfair discrimination.<sup>36</sup> The Commission has previously recognized that the markets generally distinguish between individual retail investors, whose orders are considered desirable by liquidity providers because such retail investors are presumed on average to be less informed about short-term price movements, and professional traders, whose orders are presumed on average to be more informed.<sup>37</sup> The Commission has further recognized that, because of this distinction, liquidity providers are generally more inclined to offer price improvement to less informed retail orders than to more informed professional orders.<sup>38</sup> Absent opportunities for price improvement, retail investors may

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<sup>36</sup> The comment letter discussed whether the Program’s proposed Retail Liquidity Identifier constitutes a “quote” which would be subject to Rule 610 of Regulation NMS. That rule, known as the “Fair Access Rule,” contains a similar prohibition on unfair discrimination. The Commission finds that the Program is not unfairly discriminatory under both Section 6(b)(5) of the Act and Rule 610 of Regulation NMS. Because the Commission has determined that the Program is not unfairly discriminatory pursuant to Rule 610, it need not determine whether the Retail Liquidity Identifier is a “quote” for purposes of Rule 610.

<sup>37</sup> See also Concept Release on Equity Market Structure, supra note 32; Securities Exchange Act Release No. 64781 (June 30, 2011), 76 FR 39953 (July 7, 2011) (approving a program proposed by an options exchange that would provide price improvement opportunities to retail orders based, in part, on questions about execution quality of retail orders under payment for order flow arrangements in the options markets). The commenter expressed concern that institutional investors would not be able to submit RMOs. The Commission notes that institutional investors tend to be more informed than retail investors. See supra note 29 and accompanying text.

<sup>38</sup> See also Securities Exchange Act Release No. 64781 (June 30, 2011), 76 FR 39953 (July 7, 2011) (noting that “it is well known in academic literature and industry practice that prices tend to move against market makers after trades with informed traders, often

encounter wider spreads that are a consequence of liquidity providers interacting with informed order flow. By creating additional competition for retail order flow, the Program is reasonably designed to attract retail order flow to the exchange environment, while helping to ensure that retail investors benefit from the better price that liquidity providers are willing to give their orders.

The commenter also expressed concern that the Program could create a two-tiered market and questioned the fairness of preventing institutional investors from submitting Retail Orders, and thus receiving price improvement on their orders.<sup>39</sup> The Commission notes that the Program might create a desirable opportunity for institutional investors to interact with retail order flow that they are not able to reach currently. Today, institutional investors often do not have the chance to interact with marketable retail orders that are executed pursuant to internalization arrangements. Thus, by submitting RPI Orders, institutional investors may be able to reduce their possible adverse selection costs by interacting with retail order flow.

When the Commission is engaged in rulemaking or the review of a rule filed by a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>40</sup> As discussed above, the Commission believes this Program will promote

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resulting in losses for market makers,” and that such losses are often borne by uninformed retail investors through wider spreads (citing H.R. Stoll, “The supply of dealer services in securities markets,” Journal of Finance 33 (1978), at 1133-51; L. Glosten & 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 T. Copeland & D. Galai, “Information effects on the bid-ask spread,” Journal of Finance 38 (1983), at 1457-69)).

<sup>39</sup> See supra note 29 and accompanying text.

<sup>40</sup> See 15 U.S.C. 78c(f).

competition for retail order flow by allowing Exchange members to submit RPI Orders to interact with Retail Orders. Such competition may promote efficiency by facilitating the price discovery process. Moreover, the Commission does not believe that the Program will have a significant effect on market structure, or will create any new inefficiencies in current market structure. Finally, to the extent the Program is successful in attracting retail order flow, it may generate additional investor interest in trading securities, thereby promoting capital formation.

The Commission also believes that the Program is sufficiently tailored to provide the benefits of potential price improvement only to bona fide retail order flow originating from natural persons.<sup>41</sup> The Commission finds that the Program provides an objective process by which a member organization could become a RMO, and for appropriate oversight by the Exchange to monitor for continued compliance with the terms of these provisions. The Exchange has limited the definition of Retail Order to an agency order that originates from a natural person and not a trading algorithm or any other computerized methodology. Furthermore, a Retail Order must be submitted by a RMO that is approved by the Exchange. In addition, RMOs would be required to maintain written policies and procedures to help ensure that they designate as Retail Orders only those orders which qualify under the Program. If a member's application to become a RMO is denied by the Exchange, that member may appeal the determination or re-apply. The Commission believes that these standards should help ensure that only retail order flow is submitted into the Program and thereby promote just and equitable principles of trade and protect investors and the public interest, while also providing an objective process through which members may become RMOs.

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<sup>41</sup> In addition, the Commission believes that the Program's provisions concerning the approval and potential disqualification of RMOs are not inconsistent with the Act. See RLP Approval Order, supra note 17, 77 FR at 40680 & n.77.

In addition, the Commission finds that the Program’s proposed dissemination of a Retail Liquidity Identifier would increase the amount of pricing information available to the marketplace and is consistent with the Act. The identifier would be disseminated through the consolidated public market data stream to advertise the presence of a RPI Order with which Retail Orders could interact. The identifier would reflect the symbol for a particular security and the side of the RPI Order interest, but it would not include the price or size of such interest. The identifier would alert market participants to the existence of a RPI Order and should provide market participants with more information about the availability of price improvement opportunities for retail orders than is currently available.

The commenter questioned whether the Retail Liquidity Identifier is a “quotation”.<sup>42</sup> As we note above, because the Commission has determined that the Program is not unfairly discriminatory pursuant to Rule 610, it need not determine whether the Retail Liquidity Identifier<sup>43</sup> is a “quote” for purposes of Rule 610. Furthermore, the Commission notes that the staff granted the no-action requests of the New York Stock Exchange LLC and NYSE MKT concerning Rule 602 of Regulation NMS with respect to the Retail Liquidity Identifier.<sup>44</sup>

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<sup>42</sup> “Quotation” means a bid or an offer. 17 CFR 242.601(62).

<sup>43</sup> The Commission notes that the Retail Liquidity Identifier proposed by the Exchange is identical to that used by NYSE and NYSE MKT.

<sup>44</sup> In that letter, the staff recognized the representations made by NYSE and NYSE MKT that the Retail Liquidity Identifier does not meet the definition of “bid” or “offer” in Rule 600(b)(8) of Regulation NMS because it does not communicate a specific price. See Letter from David Shillman, Associate Director, Division of Trading and Markets, to Janet McGinness, Senior Vice President-Legal and Corporate Secretary, Office of the General Counsel, NYSE Euronext, dated July 3, 2012.

A “bid” or “offer” means the bid price or the offer price communicated by a member of a national securities exchange or member of a national securities association to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of an NMS security, as either principal or agent, but shall not include indications of interest. 17 CFR 242.601(8).

The commenter also raised concerns about the additional burdens broker-dealers would face in evaluating the information contained in the identifiers to determine their routing obligations. The Commission believes that the Program will not create any best execution challenges that are not already present in today's markets. A broker's best execution obligations are determined by a number of facts and circumstances, including: (1) the character of the market for the security (e.g., price, volatility, relative liquidity, and pressure on available communications); (2) the size and type of transaction; (3) the number of markets checked; (4) accessibility of the quotation; and (5) the terms and conditions of the order which result in the transaction.<sup>45</sup> A broker would consider the Program when conducting this analysis. Given the benefits of adding this information to the marketplace, the Commission believes that the Retail Liquidity Identifier is an appropriate part of the Program.

The Exchange believes that the proposed distinctions between its Program and the approved programs for NYSE and NYSE MKT will both enhance competition amongst market participants and encourage competition amongst exchange venues.<sup>46</sup> Specifically, the Exchange believes that: allowing all Exchange Users to enter RPI Orders, as opposed to adopting a special category of retail liquidity provider, will result in a higher level of competition and maximize price improvement to incoming Retail Orders; the Program will provide the maximum price improvement available to incoming Retail Orders because they will always interact with

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The Exchange similarly requested that the staff of the Commission not recommend enforcement action to the Commission against the Exchange under the Quote Rule relating to the kind of information disseminated through Retail Liquidity Identifier. See No-Action Letter, supra note 13. The staff has determined to grant the Exchange's No-Action request pursuant to a letter which is also being issued today. See Letter from David Shillman, Associate Director, Division of Trading and Markets, to Eric Swanson, Senior Vice President and General Counsel, BATS, dated November 27, 2012.

<sup>45</sup> See FINRA Rule 5310.

<sup>46</sup> See Notice, supra note 3, 77 FR at 52346.

available contra-side RPI Orders and any other price-improving contra-side interest; and the Program will provide all of the price improvement available to incoming Retail Orders by allowing executions at multiple price levels, as opposed to a single clearing price level.<sup>47</sup> The Commission finds that the Program is reasonably designed to enhance competition amongst market participants and encourage competition amongst exchange venues. The Commission also finds that the distinctions between the Exchange's Program and the approved NYSE and NYSE MKT programs are reasonably designed to enhance the Program's price-improvement benefits to retail investors and, therefore, are consistent with the Act.

The Commission notes that it is approving the Program on a pilot basis. Approving the Program on a pilot basis will allow the Exchange and market participants to gain valuable practical experience with the Program during the pilot period. This experience should allow the Exchange and the Commission to determine whether modifications to the Program are necessary or appropriate prior to any Commission decision to approve the Program on a permanent basis. The Exchange also has agreed to provide the Commission with a significant amount of data that should assist the Commission in its evaluation of the Program. Specifically, the Exchange has represented that it "will produce data throughout the pilot, which will include statistics about participation, the frequency and level of price improvement provided by the Program, and any effects on the broader market structure."<sup>48</sup> The Commission expects that the Exchange will monitor the scope and operation of the Program and study the data produced during that time with respect to such issues, and will propose any modifications to the Program that may be necessary or appropriate.

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<sup>47</sup> See Notice, supra note 3, 77 at 53245-46.

<sup>48</sup> See supra note 37 and accompanying text.

The Commission also welcomes comments, and empirical evidence, on the Program during the pilot period to further assist the Commission in its evaluation of the Program. The Commission notes that any permanent approval of the Program would require a proposed rule change by the Exchange, and such rule change will provide an opportunity for public comment prior to further Commission action.

V. Exemption from the Sub-Penny Rule

Pursuant to its authority under Rule 612(c) of Regulation NMS,<sup>49</sup> the Commission hereby grants the Exchange a limited exemption from the Sub-Penny Rule to operate the Program.<sup>50</sup> For the reasons discussed below, the Commission determines that such action is necessary or appropriate in the public interest, and is consistent with the protection of investors. The exemption shall operate for a period of 12 months, coterminous with the effectiveness of the proposed rule change approved today.

When the Commission adopted the Sub-Penny Rule in 2005, it identified a variety of problems caused by sub-pennies that the Sub-Penny Rule was designed to address:

- If investors' limit orders lose execution priority for a nominal amount, investors may over time decline to use them, thus depriving the markets of liquidity.
- When market participants can gain execution priority for a nominal amount, important customer protection rules such as exchange priority rules and the Manning Rule could be undermined.

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<sup>49</sup> 17 CFR 242.612(c).

<sup>50</sup> The commenter opined that if the Commission believes that the protections afforded by sub-penny rule are no longer necessary, the Commission should address that change in policy through a formal rulemaking rather than individual exemptions. See supra note 30. For the reasons expressed in this section, the Commission believes that granting an exemption from Rule 612 for purposes of the BYX RLP as proposed is appropriate.

- Flickering quotations that can result from widespread sub-penny pricing could make it more difficult for broker-dealers to satisfy their best execution obligations and other regulatory responsibilities.
- Widespread sub-penny quoting could decrease market depth and lead to higher transaction costs.
- Decreasing depth at the inside could cause institutions to rely more on execution alternatives away from the exchanges, potentially increasing fragmentation in the securities markets.<sup>51</sup>

At the same time, the Commission “acknowledge[d] the possibility that the balance of costs and benefits could shift in a limited number of cases or as the markets continue to evolve.”<sup>52</sup> Therefore, the Commission also adopted Rule 612(c), which provides that the Commission may grant exemptions from the Sub-Penny Rule, either unconditionally or on specified terms and conditions, if it determined that such an exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

The Commission believes that the Exchange’s proposal raises such a case. As described above, under the current market structure, few marketable retail orders in equity securities are routed to exchanges. The vast majority of marketable retail orders are internalized by OTC market makers, who typically pay retail brokers for their order flow. Retail investors can benefit from such arrangements to the extent that OTC market makers offer them price improvement over the NBBO. Price improvement is typically offered in sub-penny amounts.<sup>53</sup> An

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<sup>51</sup> See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37551-52 (June 29, 2005).

<sup>52</sup> Id. at 37553.

<sup>53</sup> When adopting the Sub-Penny Rule, the Commission considered certain comments that asked the Commission to prohibit broker-dealers from offering sub-penny price

internalizing broker-dealer can offer sub-penny executions, provided that such executions do not result from impermissible sub-penny orders or quotations. Accordingly, OTC market makers typically select a sub-penny price for a trade without quoting at that exact amount or accepting orders from retail customers seeking that exact price. Exchanges – and exchange member firms that submit orders and quotations to exchanges – cannot compete for marketable retail order flow on the same basis, because it would be impractical for exchange electronic systems to generate sub-penny executions without exchange liquidity providers or retail brokerage firms having first submitted sub-penny orders or quotations, which the Sub-Penny Rule expressly prohibits.

The limited exemption granted today should promote competition between exchanges and OTC market makers in a manner that is reasonably designed to minimize the problems that the Commission identified when adopting the Sub-Penny Rule. Under the Program, sub-penny prices will not be disseminated through the consolidated quotation data stream, which should avoid quote flickering and its reduced depth at the inside quotation. Furthermore, while the Commission remains concerned about providing enough incentives for market participants to display limit orders, the Commission does not believe that granting this exemption (and approving the accompanying proposed rule change) will reduce such incentives. Market participants that display limit orders currently are not able to interact with marketable retail order flow because it is almost entirely routed to internalizing OTC market makers that offer sub-penny executions. Consequently, enabling the Exchanges to compete for this retail order flow through the Program should not materially detract from the current incentives to display limit orders, while potentially resulting in greater order interaction and price improvement for

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improvement to their customers, but declined to do so. The Commission stated that “trading in sub-penny increments does not raise the same concerns as sub-penny quoting” and that “sub-penny executions due to price improvement are generally beneficial to retail investors.” *Id.* at 37556.

marketable retail orders. To the extent that the Program may raise Manning and best execution issues for broker-dealers, these issues are already presented by the existing practices of OTC market makers.

The exemption being granted today is limited to a one-year pilot. The Exchange has stated that “sub-penny trading and pricing could potentially result in undesirable market behavior,” and, therefore, it will “monitor the Program in an effort to identify and address any such behavior.”<sup>54</sup> Furthermore, the Exchange has represented that it “will produce data throughout the pilot, which will include statistics about participation, the frequency and level of price improvement provided by the Program, and any effects on the broader market structure.”<sup>55</sup> The Commission expects to review the data and observations of the Exchange before determining whether and, if so, how to extend the exemption from the Sub-Penny Rule.<sup>56</sup>

## VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>57</sup> that the proposed rule change (SR-BYX-2012-019), as modified by Amendment No. 2, be and hereby is, approved on a one-year pilot basis.

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<sup>54</sup> See Request for Sub-Penny Rule Exemption, supra note 10, at 3, n.7.

<sup>55</sup> See supra note 37 and accompanying text.

<sup>56</sup> In particular, the Commission expects the Exchange to observe how maker/taker transaction charges, whether imposed by the Exchange or by other markets, might impact the use of the Program. Market distortions could arise where the size of a transaction rebate, whether for providing or taking liquidity, is greater than the size of the minimum increment permitted by the Program (\$0.001 per share).

<sup>57</sup> 15 U.S.C. 78s(b)(2).

IT IS ALSO HEREBY ORDERED that, pursuant to Rule 612(c) of Regulation NMS, the Exchange is given a limited exemption from Rule 612 of Regulation NMS allowing it to accept and rank orders priced equal to or greater than \$1.00 per share in increments of \$0.001, in the manner described in the proposed rule change above, on a one-year pilot basis coterminous with the effectiveness of the proposed rule change.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>58</sup>

Kevin O'Neill  
Deputy Secretary

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<sup>58</sup> 17 CFR 200.30-3(a)(12); 17 CFR 200.30-3(a)(83).