

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67584; File No. SR-NASDAQ-2012-066)

August 2, 2012

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Approving Proposed Rule Change, as Modified by Amendment No.1, to Adopt a New Market Maker Peg Order Available to Exchange Market Makers

I. Introduction

On June 6, 2012, 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 adopt a new Market Maker Peg Order to provide similar functionality as the automated functionality provided to market makers under Rules 4613(a)(2)(F) and (G). The proposed rule change was published for comment in the Federal Register on June 20, 2012.³ The Commission received no comment letters regarding the proposed rule change. This order approves the proposed rule change.

II. Background

NASDAQ is proposing to adopt a new Market Maker Peg Order (as defined in proposed Rule 4751(f)(15)) to provide a similar functionality presently available to Exchange market makers under Rules 4613(a)(2)(F) and (G).⁴ NASDAQ adopted Rules 4613(a)(2)(F) and (G) as

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 67203 (Jun. 20, 2012), 77 FR 37086 (“Notice”). The Commission notes that on August 2, 2012, the Exchange submitted Amendment No. 1 to the proposed rule change to make certain amendments that, in part, clarified the operation of the new Market Maker Peg Order functionality if, after entry, the Market Maker Peg Order is priced based on the consolidated last sale and such Market Maker Peg Order is established as the National Best Bid or National Best Offer.

⁴ NASDAQ will continue to offer the present automated quote management functionality

part of an effort to address issues uncovered by the aberrant trading that occurred on May 6, 2010.⁵ According to the Exchange, the automated quote management functionality (“AQ”) offered by these rules is designed to help Exchange market makers meet the enhanced market maker obligations adopted post May 6, 2010,⁶ and avoid execution of market maker “stub quotes” in instances of aberrant trading.⁷ As part of these obligations, NASDAQ requires market makers for each stock in which they are registered to continuously maintain a two-sided quotation within a designated percentage of the National Best Bid and National Best Offer⁸, as appropriate. According to NASDAQ, AQ presents difficulties to market makers in meeting their

provided to market makers under Rules 4613(a)(2)(F) and (G) for a period of 3 months after the implementation of the proposed Market Maker Peg Order. The purpose of this transition period, during which both the present automated quote management functionality under Rules 4163(a)(2)(F) and (G) and the Market Maker Peg Order will operate concurrently, is to afford market makers with the opportunity to adequately test the new Market Maker Peg Order and migrate away from the present automated quote management functionality under Rules 4613(a)(2)(F) and (G). Prior to the end of this three month period, NASDAQ represents that it will submit a rule filing to retire the automated quote management functionality under Rules 4613(a)(2)(F) and (G). See Notice, supra note 3 at 37087.

⁵ Securities Exchange Act Release No. 63255 (November 5, 2010), 75 FR 69484 (November 12, 2010) (SR-NASDAQ-2010-115, et al.).

⁶ Id.

⁷ For each issue in which a market maker is registered, AQ automatically creates a quotation for display to comply with market making obligations. Compliant displayed quotations are thereafter allowed to rest and are not further adjusted unless the relationship between the quotation and its related national best bid or national best offer, as appropriate, shrinks to the greater of: (a) 4 percentage points, or, (b) one-quarter the applicable percentage necessary to trigger an individual stock trading pause as described in Rule 4120(a)(11), or expands to within that same percentage less 0.5%, whereupon AQ will immediately re-adjust and display the market maker’s quote to the appropriate designated percentage. Quotations originally entered by market makers are allowed to move freely towards the national best bid or national best offer, as appropriate, for potential execution. In the event of an execution against a System (as defined in Rule 4751(a)) created compliant quotation, the market maker’s quote is refreshed by AQ on the executed side of the market at the applicable designated percentage away from the then national best bid (offer), or if no national best bid (offer), the last reported sale. Rule 4613(F) & (G).

⁸ As defined by Regulation NMS Rule 600(b)(42). 17 CFR 242.600.

obligations under Rule 15c3-5 under the Act (the “Market Access Rule”)⁹ and Regulation SHO.¹⁰ Specifically, the current AQ functionality offered to market makers reprices and “refreshes” a market maker’s quote when it is executed against, without any action required by the market maker. When a market maker’s quote is refreshed by the Exchange, however, the market maker has an obligation to ensure that the requirements of the Market Access Rule and Regulation SHO are met. To meet these obligations, a market maker must actively monitor the status of its quotes and ensure that the requirements of the Market Access Rule and Regulation SHO are being satisfied.

Market Maker Peg Order

In an effort to simplify market maker compliance with the requirements of the Market Access Rule and Regulation SHO, NASDAQ proposes to adopt a new order type available only to Exchange market makers, which offers AQ-like functionality but also allows a market maker to comply with the requirements of the Market Access Rule and Regulation SHO. Specifically, NASDAQ proposes to replace AQ functionality with the Market Maker Peg Order. The Market Maker Peg Order would be a one-sided limit order and similar to other peg orders available to market participants in that the order is tied or “pegged” to a certain price,¹¹ but it would not be eligible for routing pursuant Rule 4758 and would always be displayed and attributable (as defined in Rule 4751). The Market Maker Peg Order would be limited to market makers and would have its price automatically set and adjusted, both upon entry and any time thereafter, in order to comply with the Exchange’s rules regarding market maker quotation requirements and

⁹ See Notice, *supra* note 3 at 37087.

¹⁰ 17 CFR 242.200 through 204.

¹¹ Rule 4751(f)(4) defines Pegged Orders.

obligations.¹² It is expected that market makers will perform the necessary checks to comply with Regulation SHO, as discussed above, prior to entry of a Market Maker Peg Order. Upon entry and at any time the order exceeds either the Defined Limit, as described in Rule 4613(a)(2)(E), or moves a specified number of percentage points away from the Designated Percentage towards the then current National Best Bid or National Best Offer, as described in Rule 4613(a)(2)(F), the Market Maker Peg Order would be priced by the Exchange at the Designated Percentage¹³ away from the then current National Best Bid and National Best Offer, or, if no National Best Bid or National Best Offer, to the Designated Percentage away from the last reported sale from the responsible single plan processor. According to NASDAQ, in the absence of a National Best Bid or National Best Offer and last reported sale, the order will be cancelled or rejected. Adjustment to the Designated Percentage is designed to avoid an execution against a Market Maker Peg Order that would initiate a single stock circuit breaker. In the event of an execution against a Market Maker Peg Order that reduces the size of the Market Maker Peg Order below one round lot, the market maker would need to enter a new order, after performing the regulatory checks discussed above, to satisfy their obligations under Rule 4613.¹⁴ In the event that pricing the Market Maker Peg Order at the Designated Percentage away from the then current National Best Bid and National Best Offer, or, if no National Best Bid or National Best Offer, to the Designated Percentage away from the last reported sale from the

¹² The Market Maker Peg Order is one-sided so a market maker seeking to use Market Maker Peg Orders to comply with the Exchange's rules regarding market maker quotation requirements would need to submit both a bid and an offer using the order type.

¹³ The Designated Percentage is the individual stock pause trigger percentage under Rule 4120(a)(11) (or comparable rule of another exchange) less two (2) percentage points. See Rule 4613(a)(2)(D).

¹⁴ Rule 4613 generally sets forth NASDAQ market maker requirements, which include quotation and pricing obligations, and the firm quote obligation.

responsible single plan processor would result in the order exceeding its limit price, the order will be cancelled or rejected.

NASDAQ is also proposing to allow a market maker to designate an offset more aggressive (i.e., smaller) than the Designated Percentage for any given Market Maker Peg Order. This functionality will allow a market maker to quote at price levels that are closer to the National Best Bid and National Best Offer if it elects to do so. To use this functionality, a market maker must designate the desired offset upon order entry.¹⁵ Thereafter and unlike the default¹⁶ Market Maker Peg Order, a Market Maker Peg Order with a market maker-designated offset will have its price automatically adjusted on a tick-by-tick basis by the System to maintain the market maker-designated offset from the National Best Bid or National Best Offer until the order is executed or cancelled.¹⁷ In the absence of a National Best Bid or National Best Offer, Market Maker Peg Orders with a market maker-designated offset will be cancelled or rejected. In the event that pricing the Market Maker Peg Order at the market maker-designated offset

¹⁵ If a market maker wishes, it can designate a more aggressive bid while using the Defined Percentage and Defined Limit for its offer, or vice versa.

¹⁶ In the absence of an offset designation, a Market Maker Peg Order will default to using the Defined Percentage and Defined Limit, and the repricing process whereby, upon reaching the Defined Limit, the price of a Market Maker Peg Order bid or offer will be adjusted by the System to the Designated Percentage away from the then current National Best Bid or National Best Offer, or, if no National Best Bid or National Best Offer, to the Designated Percentage away from the last reported sale from the responsible single plan processor.

¹⁷ Market Maker Peg Orders with a market maker-designated offset may be able to qualify as bona-fide market making for purposes of Regulation SHO, depending on the facts and circumstances. A market maker entering such an order must consider the factors set forth by the Commission in determining whether reliance on the exception from the “locate” requirement of Rule 203 for bona-fide market making is appropriate with respect to the particular Market Maker Peg Order and its designated offset. See supra note 11.

away from the then current National Best Bid and National Best Offer would result in the order exceeding its limit price, the order will be cancelled or rejected.¹⁸

NASDAQ claims that this order-based approach is superior in terms of the ease in complying with the requirements of the Market Access Rule and Regulation SHO while also providing similar quote adjusting functionality to its market makers.¹⁹ NASDAQ also states that market makers would have control of order origination, as required by the Market Access Rule, while also allowing market makers to make marking and locate determinations prior to order entry, as required by Regulation SHO. The Exchange claims that this will allow market makers to fully comply with the requirements of the Market Access Rule and Regulation SHO, as they would when placing any order, while also meeting their Exchange market making obligations.²⁰

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.²¹ Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,²² which requires, among other things, the rules of an exchange 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

¹⁸ The Market Maker Peg Order will be accepted and executable during System hours. During pre and post-market hours, the wider Designated Percentage and Defined Limit associated with the 9:30 a.m. - 9:45 a.m. and 3:35 p.m. - 4:00 p.m. periods under Rule 4613(a)(2)(D) and (E) will be applied.

¹⁹ See Notice, supra note 3 at 37088.

²⁰ See id.

²¹ 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).

²² 15 U.S.C. 78f(b)(5).

investors and the public interest. The Commission finds that the proposed rule change also is designed to support the principles of Section 11A(a)(1)²³ of the Act in that it seeks to assure fair competition among brokers and dealers and among exchange markets.

The Commission finds that the Exchange's proposal is consistent with the Act because it provides a means through which market makers may meet their minimum quoting requirements, which may assist in the maintenance of fair and orderly markets, provide additional liquidity to the Exchange, and prevent excessive volatility. At the same time, the proposal is reasonably designed to assist market makers in complying with the regulatory requirements of the Market Access Rule and Regulation SHO. The Commission notes, however, that the Market Maker Peg Order, like the current AQ system, does not ensure that the market maker is satisfying the requirements of the Market Access Rule or Regulation SHO, including the satisfaction of the locate requirement of Rule 203(b)(1) or an exception thereto. The Commission also notes that, in the event a Market Maker Peg Order is executed against such that the Market Maker Peg Order is reduced in size to below one round lot, the market maker would need to perform the necessary regulatory checks pursuant to the Market Access Rule and Regulation SHO prior to entering a new Market Maker Peg Order.

The Commission also believes that providing Exchange market makers with a transition period, during which they may adequately test the new functionality of the Market Maker Peg Order, will serve to minimize the potential market impact caused by the implementation of that order type. In addition, by allowing market makers to enter a Market Maker Peg Order that is priced more aggressively than the Designated Percentage, the proposed rules are reasonably

²³ 15 U.S.C. 78k-1(a)(1).

designed to provide that quotations submitted by market makers to the Exchange, and displayed to market participants, bear some relationship to the prevailing market price.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁴ that the proposed rule change, as modified by Amendment No.1, (SR-NASDAQ-2012-066) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁵

Kevin M. O'Neill
Deputy Secretary

²⁴ 15 U.S.C. 78s(b)(2).

²⁵ 17 CFR 200.30-3(a)(12).