

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69341; File No. SR-NASDAQ-2013-048)

April 8, 2013

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Granting Accelerated Approval of a Proposed Rule Change to Adopt Chapter V, Section 3 Subparagraph (d)(iv) Regarding Obvious Error or Catastrophic Error Review

I. Introduction

On March 14, 2013, The NASDAQ Stock Market LLC (“Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to provide for how the Exchange proposes to treat obvious and catastrophic options errors in response to the Regulation NMS Plan to Address Extraordinary Market Volatility (the “Plan”). The proposed rule change was published for comment in the Federal Register on March 20, 2013.³ The Commission received one comment letter on the proposal.⁴ This order approves the proposed rule change on an accelerated basis.

II. Description of the Proposed Rule Change

Since May 6, 2010, when the financial markets experienced a severe disruption, the equities exchanges and the Financial Industry Regulatory Authority have developed market-wide measures to help prevent a recurrence. In particular, on May 31, 2012, the Commission approved the Plan, as amended, on a one-year pilot basis.⁵ The Plan is designed to prevent trades

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 69142 (March 15, 2013), 78 FR 17251 (“Notice”).

⁴ See Letter to Heather Seidel, Associate Director, Division of Trading and Markets, Commission, from Thomas A. Wittman, Senior Vice President, The NASDAQ Stock Market LLC, dated April 5, 2013 (“Nasdaq Letter”).

⁵ Securities Exchange Act Release No. 67091 (May 31, 2012), 77 FR 33498.

in individual NMS stocks from occurring outside of specified Price Bands, creating a market-wide limit up-limit down mechanism that is intended to address extraordinary market volatility in NMS Stocks.⁶

In connection with the implementation of the Plan, the Exchange proposes to adopt new Chapter V, Section 3(d)(iv) to exclude trades that occur during a Limit State or Straddle State from the obvious error or catastrophic error review procedures pursuant to Chapter V, Sections 6(b) or 6(f), for a one year pilot basis from the date of adoption of the proposed rule change.⁷ The Exchange proposes to retain the ability to review trades that occur during a Limit State or Straddle State by Exchange motion pursuant to Chapter V, Section 6(d)(i).

Under Sections 6(b)(i) and (f)(i), obvious and catastrophic errors are calculated by determining a theoretical price and applying such price to ascertain whether the trade should be nullified or adjusted. Obvious and catastrophic errors are determined by comparing the theoretical price of the option, calculated by one of the methods in Section 6(c), to an adjustment table in Section 6(b)(i) for obvious errors or Section 6(f)(i) for catastrophic errors. Generally, the theoretical price of an option is the National Best Bid and Offer (“NBBO”) of the option. In certain circumstances, Exchange officials have the discretion to determine the theoretical price.⁸

⁶ Unless otherwise specified, capitalized terms used in this rule filing are based on the defined terms of the Plan.

⁷ The Exchange stated that various members of the Exchange staff have spoken to a number of member organizations about obvious and catastrophic errors during a Limit State or Straddle State and that a variety of viewpoints emerged, mostly focused on having many trades stand, on fairness and fair and orderly markets and on being able to re-address the details during the course of the pilot, if needed.

⁸ Specifically, under Section 6(c), the theoretical price is determined in one of two ways: (i) if the series is traded on at least one other options exchange, the last National Best Bid price with respect to an erroneous sell transaction and the last National Best Offer price with respect to an erroneous buy transaction, just prior to the transaction; or (ii) as determined by MarketWatch as defined in Chapter I, if there are no quotes for comparison purposes.

The Exchange believes that neither of these methods is appropriate during a Limit State or Straddle State. Under Section 6(c)(i), the theoretical price is determined with respect to the NBBO for an option series just prior to the trade. According to the Exchange, during a Limit State or Straddle State, options prices may deviate substantially from those available prior to or following the state. The Exchange believes this provision would give rise to much uncertainty for market participants as there is no bright line definition of what the theoretical price should be for an option when the underlying NMS stock has an unexecutable bid or offer or both. Because the approach under Section 6(c)(i) by definition depends on a reliable NBBO, the Exchange does not believe that approach is appropriate during a Limit State or Straddle State. Additionally, because the Exchange system will only trade through the theoretical bid or offer if the Exchange or the participant (via an ISO order) has accessed all better priced interest away in accordance with the Options Order Protection and Locked/Crossed Markets Plan, the Exchange believes potential trade reviews of executions that occurred at the participant's limit price and also in compliance with the aforementioned Plan could harm liquidity and also create an advantage to either side of an execution depending on the future movement of the underlying stock.

With respect to Section 6(c)(ii), affording discretion to Exchange staff to determine the theoretical price and thereby, ultimately, whether a trade is busted or adjusted and to what price, the Exchange notes that it would be difficult to exercise such discretion in periods of extraordinary market volatility and, in particular, when the price of the underlying security is unreliable. The Exchange again notes that the theoretical price in this context would be subjective. Ultimately, the Exchange believes that adding certainty to the execution of orders in these situations should encourage market participants to continue to provide liquidity to the Exchange, thus promoting fair and orderly markets. On balance, the Exchange believes that

removing the potential inequity of nullifying or adjusting executions occurring during Limit States or Straddle States outweighs any potential benefits from applying these provisions during such unusual market conditions.

Additionally, the Exchange proposes to provide that trades would not be subject to review under Section 6(b)(ii) during a Limit or Straddle State. Under Section 6(b)(ii), a trade may be nullified or adjusted where an execution occurred in a series quoted no bid. The Exchange believes that these situations are not appropriate for an error review because they are more likely to result in a windfall to one party at the expense of another in a Limit State or Straddle State, because the criteria for meeting the no-bid provision are more likely to be met in a Limit State or Straddle State, and unlike normal circumstances, may not be a true reflection of the value of the series being quoted.

In response to these concerns, the Exchange proposes to adopt Section 3(d)(iv) to provide that trades are not subject to an obvious error or catastrophic error review pursuant to Section 6(b) and 6(f) during a Limit State or Straddle State. In addition, proposed Section 3(d)(iv) also will include a qualification that nothing in proposed Section 3(d)(iv) will prevent electronic trades from being reviewed on Exchange motion pursuant to Section 6(d)(i). According to the Exchange, this safeguard will provide the flexibility to act when necessary and appropriate, while also providing market participants with certainty that trades they effect with quotes and/or orders having limit prices will stand irrespective of subsequent moves in the underlying security. The right to review on Exchange motion electronic transactions that occur during a Limit State or Straddle State under this provision, according to the Exchange, would enable the Exchange to account for unforeseen circumstances that result in obvious or catastrophic errors for which a

nullification or adjustment may be necessary in order to preserve the interest of maintaining a fair and orderly market and for the protection of investors.

III. Discussion

The Commission finds that the Exchange's proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.⁹ Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,¹⁰ in that it is designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, protect investors and the public interest.

In the filing, the Exchange notes its belief that suspending certain aspects of Chapter V, Section 6 during a Limit State or Straddle State will ensure that limit orders that are filled during a Limit or Straddle State will have certainty of execution in a manner that promotes just and equitable principles of trade and removes impediments to, and perfects the mechanism of, a free and open market and a national market system. The Exchange believes the application of the current rule would be impracticable given what it perceives will be the lack of a reliable NBBO in the options market during Limit States and Straddle States, and that the resulting actions (i.e., nullified trades or adjusted prices) may not be appropriate given market conditions. In addition, given the Exchange's view that options prices during Limit States or Straddle States may deviate

⁹ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹⁰ 15 U.S.C. 78f(b)(5).

substantially from those available shortly following the Limit State or Straddle State, the Exchange believes that providing market participants time to re-evaluate a transaction executed during a Limit or Straddle State will create an unreasonable adverse selection opportunity that will discourage participants from providing liquidity during Limit States or Straddle States. Ultimately, the Exchange believes that adding certainty to the execution of orders in these situations should encourage market participants to continue to provide liquidity to the Exchange during Limit States and Straddle States, thus promoting fair and orderly markets.

The Exchange, however, has proposed this rule change based on its expectations about the quality of the options market during Limit States and Straddle States. The Exchange states, for example, that it believes that application of the obvious and catastrophic error rules would be impracticable given the potential for lack of a reliable NBBO in the options market during Limit States and Straddle States. Given the Exchange's recognition of the potential for unreliable NBBOs in the options markets during Limit States and Straddle States, the Commission is concerned about the extent to which investors may rely to their detriment on the quality of quotations and price discovery in the options markets during these periods. This concern is heightened by the Exchange's proposal to exclude trades that occur during a Limit State or Straddle State from the obvious error or catastrophic error review procedures pursuant to Section 6(b) or 6(f). The Commission urges investors and market professionals to exercise caution when considering trading options under these circumstances. Broker-dealers also should be mindful of their obligations to customers that may or may not be aware of specific options market conditions or the underlying stock market conditions when placing their orders.

While the Commission remains concerned about the quality of the options market during the Limit and Straddle States, and the potential impact on investors of executing in this market

without the protections of the obvious or catastrophic error rules that are being suspended during the Limit and Straddle States, it believes that certain aspects of the proposal could help mitigate those concerns.

First, despite the removal of obvious and catastrophic error protection during Limit States and Straddle States, the Exchange states that there are additional measures in place designed to protect investors. For example, the Exchange states that by rejecting market orders and stop orders, and cancelling pending market orders and stop orders, only those orders with a limit price will be executed during a Limit State or Straddle State. Additionally, the Exchange notes the existence of SEC Rule 15c3-5 requiring broker-dealers to have controls and procedures in place that are reasonably designed to prevent the entry of erroneous orders. Finally, with respect to limit orders that will be executable during Limit States and Straddle States, the Exchange states that it applies price checks to limit orders that are priced sufficiently far through the NBBO. Therefore, on balance, the Exchange believes that removing the potential inequity of nullifying or adjusting executions occurring during Limit States or Straddle States outweighs any potential benefits from applying certain provisions during such unusual market conditions.

The Exchange also believes that the aspect of the proposed rule change that will continue to allow the Exchange to review on its own motion electronic trades that occur during a Limit State or a Straddle State is consistent with the Act because it would provide flexibility for the Exchange to act when necessary and appropriate to nullify or adjust a transaction and will enable the Exchange to account for unforeseen circumstances that result in obvious or catastrophic errors for which a nullification or adjustment may be necessary in order to preserve the interest of maintaining a fair and orderly market and for the protection of investors. The Exchange represents that it recognizes that this provision is limited and that it will administer the provision

in a manner that is consistent with the principles of the Act. In addition, the Exchange represents that it will create and maintain records relating to the use of the authority to act on its own motion during a Limit State or Straddle State.

Finally, the Exchange has proposed that the changes be implemented on a one year pilot basis. The Commission believes that it is important to implement the proposal as a pilot. The one year pilot period will allow the Exchange time to assess the impact of the Plan on the options marketplace and allow the Commission to further evaluate the effect of the proposal prior to any proposal or determination to make the changes permanent. To this end, the Exchange has committed to: (1) evaluate the options market quality during Limit States and Straddle States; (2) assess the character of incoming order flow and transactions during Limit States and Straddle States; and (3) review any complaints from members and their customers concerning executions during Limit States and Straddle States. Additionally, the Exchange has agreed to provide the Commission with data requested to evaluate the impact of the elimination of the obvious error rule, including data relevant to assessing the various analyses noted above. On April 5, 2013, the Exchange submitted a letter stating that it would provide specific data to the Commission and the public and certain analysis to the Commission to evaluate the impact of Limit States and Straddle States on liquidity and market quality in the options markets.¹¹ This will allow the Commission,

¹¹ In particular, the Exchange represented that, at least two months prior to the end of the one year pilot period of proposed Section 3(d)(iv), it would provide to the Commission an evaluation of (i) the statistical and economic impact of Straddle States on liquidity and market quality in the options market and (ii) whether the lack of obvious error rules in effect during the Limit States and Straddle States are problematic. In addition, the Exchange represented that each month following the adoption of the proposed rule change it would provide to the Commission and the public a dataset containing certain data elements for each Limit State and Straddle State in optionable stocks. The Exchange stated that the options included in the dataset will be those that meet the following conditions: (i) the options are more than 20% in the money (strike price remains greater than 80% of the last stock trade price for calls and strike price remains greater than 120%

the Exchange, and other interested parties to evaluate the quality of the options markets during Limit States and Straddle States and to assess whether the additional protections noted by the Exchange are sufficient safeguards against the submission of erroneous trades, and whether the Exchange's proposal appropriately balances the protection afforded to an erroneous order sender against the potential hazards associated with providing market participants additional time to review trades submitted during a Limit State or Straddle State.

Finally, the Commission notes that the Plan, to which these rules relate, will be implemented on April 8, 2013. Accordingly, for the reasons stated above, and in consideration of the April 8, 2013 implementation date of the Plan, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,¹² for approving the Exchange's proposal prior to the 30th day after the publication of the notice in the Federal Register.

of the last stock trade price for puts when the Limit State or Straddle State is reached); (ii) the option has at least two trades during the Limit State or Straddle State; and (iii) the top ten options (as ranked by overall contract volume on that day) meeting the conditions listed above. For each of those options affected, each dataset will include, among other information: stock symbol, option symbol, time at the start of the Limit State or Straddle State and an indicator for whether it is a Limit State or Straddle State. For activity on the Exchange in the relevant options, the Exchange has agreed to provide executed volume, time-weighted quoted bid-ask spread, time-weighted average quoted depth at the bid, time-weighted average quoted depth at the offer, high execution price, low execution price, number of trades for which a request for review for error was received during Limit States and Straddle States, an indicator variable for whether those options outlined above have a price change exceeding 30% during the underlying stock's Limit State or Straddle State compared to the last available option price as reported by OPRA before the start of the Limit or Straddle state (1 if observe 30% and 0 otherwise), and another indicator variable for whether the option price within five minutes of the underlying stock leaving the Limit State or Straddle State (or halt if applicable) is 30% away from the price before the start of the Limit State or Straddle State. See Nasdaq Letter, supra note 4.

¹² 15 U.S.C. 78s(b)(2). The Commission noticed substantially similar rules proposed by NYSE MKT LLC and NYSE Arca, Inc. with a full 21 day comment period. See Securities Exchange Act Release No. 69033, 78 FR 15067 (March 8, 2013) and Securities Exchange Act Release No. 69032, 78 FR 15080 (March 8, 2013).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹³ that the proposed rule change (SR-NASDAQ-2013-048), be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁴

Kevin M. O'Neill
Deputy Secretary

¹³ 15 U.S.C. 78s(b)(2).

¹⁴ 17 CFR 200.30-3(a)(12).