

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-71902; File No. SR-NASDAQ-2014-033)

April 8, 2014

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Extend the Pilot Program Regarding Options Obvious and Catastrophic Errors in Response to the Regulation NMS Plan to Address Extraordinary Market Volatility

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> notice is hereby given that, on April 7, 2014, The NASDAQ Stock Market LLC (“Nasdaq” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I and II, below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange is submitting a proposal by the NASDAQ Options Market (“NOM”) to amend Chapter V, Regulation of Trading on NOM, to extend the pilot program under Section 3(d)(iv), which provides for how the Exchange treats obvious and catastrophic options errors in response to the Plan to Address Extraordinary Market Volatility Pursuant to Rule 608 of Regulation NMS under the Act (the “Limit Up-Limit Down Plan” or the “Plan”).<sup>3</sup> The Exchange proposes to extend the pilot period until February 20, 2015.

The text of the proposed rule change is available on the Exchange’s website

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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> Securities Exchange Act Release Nos. 69142 (March 15, 2013), 78 FR 17251 (March 20, 2013); and 69341 (April 8, 2013), 78 FR 21996 (April 12, 2013) (SR-NASDAQ-2013-048).

at <http://nasdaq.cchwallstreet.com>, at the principal office of the Exchange, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

In April 2013, the Commission approved a proposal, on a one year pilot basis, to adopt Chapter V, Section 3(d)(iv) to provide for how the Exchange will treat obvious and catastrophic options errors in response to the Plan, which is applicable to all NMS stocks, as defined in Regulation NMS Rule 600(b)(47).<sup>4</sup> The Plan is designed to prevent trades in individual NMS stocks from occurring outside of specified Price Bands.<sup>5</sup> The requirements of the Plan are coupled with Trading Pauses to accommodate more fundamental price moves (as opposed to erroneous trades or momentary gaps in liquidity).

The Exchange proposes to extend the operation of Chapter V, Section 3(d)(iv), which provides that trades are not subject to an obvious error or catastrophic error review pursuant to

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<sup>4</sup> The Plan was recently proposed to be extended until February 20, 2015. See Securities Exchange Act Release No. 71649 (March 8, 2014), 79 FR 13696 (March 11, 2014) (File No. 4-631). The Plan was initially approved for a one-year pilot, which began on April 8, 2013 and the pilot period is currently scheduled to end on April 8, 2014.

<sup>5</sup> Unless otherwise specified, capitalized terms used in this rule filing are based on the defined terms of the Plan.

Section 3 during a Limit State or Straddle State, for an additional pilot period ending February 20, 2015.<sup>6</sup> The Exchange believes conducting an obvious error or catastrophic error review is impracticable given the lack of a reliable National Best Bid/Offer (“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. Under the pilot, limit orders that are filled during a Limit State or Straddle State have certainty of execution in a manner that promotes just and equitable principles of trade, removes impediments to, and perfects the mechanism of a free and open market and a national market system. Moreover, given that options prices during brief Limit States or Straddle States may deviate substantially from those available shortly following the Limit State or Straddle State, the Exchange believes giving market participants time to re-evaluate a transaction would create an unreasonable adverse selection opportunity that would discourage participants from providing liquidity during Limit States or Straddle States. 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 those provisions during such unusual market conditions.

The Exchange believes the benefits to market participants from the pilot program should continue on a pilot basis to coincide with the operation of the Limit Up-Limit Down Plan. The Exchange believes that continuing the pilot will protect against any unanticipated consequences and permit the industry to gain further experience operating the Plan.

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<sup>6</sup> The Exchange also proposes to correct paragraph (d), which provides that such provision is in effect during a pilot period to coincide with the pilot period for the Plan, except as specified in subparagraph (v) (the obvious error provision that is the subject of this proposal), to reflect that the exception applies to subparagraph (iv) rather than (v). There is no paragraph (v).

The Exchange will conduct an analysis concerning the elimination of obvious and catastrophic error provisions during Limit States and Straddle States and agrees to provide the Commission with relevant data to assess the impact of this proposed rule change. As part of its analysis, the Exchange will: (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 agrees to provide to the Commission data requested to evaluate the impact of the elimination of the obvious and catastrophic error provisions, including data relevant to assessing the various analyses noted above. By September 30, 2014, the Exchange shall provide to the Commission assessments relating to the impact of the operation of the obvious error rules during Limit and Straddle States as follows:

1. Evaluate the statistical and economic impact of Limit and Straddle States on liquidity and market quality in the options markets.
2. Assess whether the lack of obvious error rules in effect during the Straddle and Limit States are problematic.

Each month the Exchange shall provide to the SEC and the public a dataset containing the data for each Straddle and Limit State in optionable stocks that had at least one trade on the Exchange during a Straddle or Limit State. For each of those options affected, each data record should contain the following information:

- Stock symbol, option symbol, time at the start of the straddle or limit state, an indicator for whether it is a straddle or limit state,
- For activity on the Exchange:

- 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 Straddle and Limit States,
- an indicator variable for whether those options outlined above have a price change exceeding 30% during the underlying stock's Limit 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).

Another indicator variable for whether the option price within five minutes of the underlying stock leaving the Limit or Straddle state (or halt if applicable) is 30% away from the price before the start of the Limit or Straddle state.<sup>7</sup>

## 2. Statutory Basis

The Exchange believes the proposed rule change is consistent with the provisions of Section 6 of the Act,<sup>8</sup> in general and with Section 6(b)(5) of the Act,<sup>9</sup> in particular, which requires that the rules of an exchange be designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a

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<sup>7</sup> The Exchange agreed to provide similar data in the original proposal. See Securities Exchange Act Release No. 69341 (April 8, 2013), 78 FR 21996 (April 12, 2013) (SR-NASDAQ-2013-048) at notes 4 and 11. However, that data included two additional filters pertaining to the top 10 options and an in-the-money amount, which will no longer apply. The Exchange intends to provide historical data in the new form pursuant to this proposed rule change, going back to the beginning of the original pilot period once such data can be reasonably compiled.

<sup>8</sup> 15 U.S.C. 78f.

<sup>9</sup> 15 U.S.C. 78f(b)(5).

national market system, and, in general, protect investors and the public interest, because it should continue to provide certainty about how errors involving options orders and trades will be handled during periods of extraordinary volatility in the underlying security. The Exchange believes that it continues to be necessary and appropriate in the interest of promoting fair and orderly markets to exclude transactions executed during a Limit State or Straddle State from certain aspects of Chapter V, Section 6.<sup>10</sup>

Although the Limit Up-Limit Down Plan is operational, the Exchange believes that maintaining the pilot will help the industry gain further experience operating the Plan as well as the pilot provisions.

Based on the foregoing, the Exchange believes the benefits to market participants should continue on a pilot basis to coincide with the operation of the Limit Up-Limit Down Plan.

**B. Self-Regulatory Organization's Statement on Burden on Competition**

The Exchange does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended. Specifically, the proposal does not impose an intra-market burden on competition, because it will apply to all members. Nor will the proposal impose a burden on competition among the options exchanges, because, in addition to the vigorous competition for order flow among the options exchanges, the proposal addresses a regulatory situation common to all options exchanges. To the extent that market participants disagree with the particular approach taken by the Exchange herein, market participants can easily and readily direct order flow to competing venues. The Exchange believes this proposal will not impose a burden on

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<sup>10</sup> The Exchange also believes that the proposal to correct the reference to subparagraph (iv) in paragraph (d) is consistent with promoting just and equitable principles of trade, because it corrects the rule to make it more understandable to participants.

competition and will help provide certainty during periods of extraordinary volatility in an NMS stock.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were either solicited or received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the proposed rule change does not (i) significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, the proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Act<sup>11</sup> and Rule 19b-4(f)(6)(iii) thereunder.<sup>12</sup>

The Exchange has asked the Commission to waive the 30-day operative delay so that the proposal may become operative immediately upon filing. The Exchange stated that waiver of this requirement will allow the Exchange to extend the pilot program prior to its expiration on April 8, 2014. The Exchange also stated that waiver of this requirement would ensure the pilot program would align with the pilot period for the Plan and would ensure that trading in options that overlay NMS Stocks continues to be appropriately modified to reflect market conditions that occur during a Limit State or a Straddle State. For these reasons, the Commission believes that the proposed rule change presents no novel issues and that waiver of the 30-day operative delay

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<sup>11</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>12</sup> 17 CFR 240.19b-4(f)(6)(iii). As required under Rule 19b-4(f)(6)(iii), the Exchange provided the Commission with written notice of its intent to file the proposed rule change, along with a brief description and the text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission.

is consistent with the protection of investors and the public interest. Therefore, the Commission designates the proposed rule change to be operative upon filing.<sup>13</sup>

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASDAQ-2014-033 on the subject line.

##### Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2014-033. This file number should be included on the subject line if e-mail is used. To help the Commission process and review

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<sup>13</sup> For purposes only of waiving the 30-day operative delay, the Commission has also considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).



your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer

to File Number SR-NASDAQ-2014-033 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

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

Kevin M. O'Neill  
Deputy Secretary

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<sup>14</sup> 17 CFR 200.30-3(a)(12).