

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-81150; File Nos. SR-NYSE-2016-71 and SR-NYSEMKT 2016-99)

July 14, 2017

Self-Regulatory Organizations; New York Stock Exchange LLC; NYSE MKT LLC; Order Disapproving Proposed Rule Changes Amending Exchange Rule 104 to Delete Subsection (g)(i)(A)(III), Which Prohibits Designated Market Makers from Engaging in Transactions, During the Last Ten Minutes of Trading Before the Close, that Establish a New High (Low) Price for the Day on the Exchange in an Assigned Security in Which the DMM Has a Long (Short) Position

I. Introduction

On October 27, 2016, New York Stock Exchange LLC (“NYSE”) and NYSE MKT LLC (“NYSE MKT”) (each an “Exchange,” and collectively the “Exchanges”) each filed with the Securities and Exchange Commission (“Commission”) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change amending its respective Rule 104 to delete subsection (g)(i)(A)(III)—“Prohibited Transactions.”³ Exchange Rule 104(g)(i)(A)(III) prohibits Designated Market Makers (“DMMs”) from engaging in a transaction that establishes, during the last ten minutes of trading before the close, a new high (low) price for the day on the Exchange in an assigned security in

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ This order refers to both NYSE Rule 104 and NYSE MKT Rule 104 – Equities as “Exchange Rule 104.” NYSE MKT Rule 104 – Equities is based on and, in relevant part, substantively identical to NYSE Rule 104. See Securities Exchange Act Release Nos. 58705 (Oct. 1, 2008), 73 FR 58995 (Oct. 8, 2008) (SR-Amex-2008-63) and 59022 (Nov. 26, 2008), 73 FR 73683 (Dec. 3, 2008) (amending NYSE MKT equity rules to conform to NYSE New Market Model Pilot rules).

which the DMM has a long (short) position (“Prohibited Transactions Rule”). The proposed rule changes were published for comment in the Federal Register on November 17, 2016.⁴

On December 20, 2016, the Commission extended to February 15, 2017, the time period in which to approve or disapprove the proposed rule changes or to institute proceedings to determine whether to approve or disapprove the proposals.⁵ On February 15, 2017, the Commission instituted proceedings to determine whether to approve or disapprove the proposed rule changes.⁶ The Commission then received a comment letter, as well as a combined response letter from NYSE and NYSE MKT.⁷ On April 28, 2017, the Commission designated a longer period for Commission action on proceedings to determine whether to approve or disapprove the proposed rule changes.⁸ This order disapproves the proposed rule changes.

⁴ See Securities Exchange Act Release Nos. 79284 (Nov. 10, 2016), 81 FR 81222 (Nov. 17, 2016) (“NYSE Notice”) and 79283 (Nov. 10, 2016), 81 FR 81210 (Nov. 17, 2016) (“NYSE MKT Notice”).

⁵ See Securities Exchange Act Release Nos. 79612 (Dec. 20, 2016), 81 FR 95205 (Dec. 27, 2016) and 79611 (Dec. 20, 2016), 81 FR 95205 (Dec. 27, 2016).

⁶ See Securities Exchange Act Release Nos. 80044 (Feb. 15, 2017), 82 FR 11388 (Feb. 22, 2017) (“NYSE Order Instituting Proceedings”) and 80043 (Feb. 15, 2017), 82 FR 11379 (Feb. 22, 2017) (“NYSE MKT Order Instituting Proceedings”) (collectively, the “Orders Instituting Proceedings”).

⁷ See Letter from Stephen John Berger, Managing Director, Government and Regulatory Policy, Citadel Securities, to Brent J. Fields, Secretary, Commission (Mar. 15, 2017) (“Citadel Letter”); Letter from Elizabeth K. King, General Counsel and Corporate Secretary, NYSE, to Brent J. Fields, Secretary, Commission (Mar. 16, 2017) (“NYSE Letter”). The Citadel Letter addressed only the NYSE proposal, which is substantively identical to the NYSE MKT proposal. The NYSE Letter was submitted on behalf of both NYSE and NYSE MKT.

⁸ See Securities Exchange Act Release Nos. 80552 (Apr. 28, 2017), 82 FR 20927 (May 4, 2017) and 80550 (Apr. 28, 2017), 82 FR 20926 (May 4, 2017).

II. Description of the Proposals

Currently, under Exchange Rule 104(g)(i)(A)(III), a DMM with a long (short) position in an assigned security cannot, during the last ten minutes before the close of trading, make a purchase (sale) in that security that results in a new high (low) price on the Exchange for the day.⁹ The Prohibited Transactions Rule provides two exceptions that permit a DMM to: (1) match another market's better bid or offer price; or (2) bring the price of a security into parity with an underlying or related security or asset.¹⁰ The Exchanges propose to remove the Prohibited Transactions Rule from their rulebooks.

The Exchanges assert that, in light of developments in the equity markets and in their trading model, the Prohibited Transactions Rule has lost its original purpose and utility.¹¹ Specifically, the Exchanges assert that in today's electronic marketplace—where DMMs have replaced specialists and control of pricing decisions has moved away from market participants on the Exchange trading floor—the Prohibited Transactions Rule is no longer necessary.¹² According to the Exchanges, eliminating the Prohibited Transactions Rule would not eliminate other existing safeguards that prevent DMMs from inappropriately influencing or manipulating the close.¹³

⁹ See Exchange Rule 104(g)(i)(A)(III).

¹⁰ See id.; see also Exchange Rule 104(g)(i)(A)(II)(2)(i).

¹¹ See NYSE Notice, supra note 4, 81 FR at 81223; NYSE MKT Notice, supra note 4, 81 FR at 81211.

¹² See NYSE Notice, supra note 4, 81 FR at 81222; NYSE MKT Notice, supra note 4, 81 FR at 81212.

¹³ See NYSE Notice, supra note 4, 81 FR at 81222–23; NYSE MKT Notice, supra note 4, 81 FR at 81212.

The Exchanges assert that the rationale behind the Prohibited Transactions Rule—preventing specialists from setting the price of a security on the Exchange in the final ten minutes of trading—was to prevent a specialist from inappropriately influencing the price of a security at the close to advantage the specialist’s proprietary position.¹⁴ According to the Exchanges, in today’s fragmented marketplace, a new high (low) price for a security on one of the Exchanges in the last ten minutes of trading does not have a significant effect on the market price for that security, because a new high (low) price on one of the Exchanges may not be the new high (low) market-wide price for a security—prices may be higher (lower) in away markets, where the majority of intra-day trading in Exchange-listed securities takes place—and because any advantage to a DMM from establishing a new high or low on the Exchange during the last ten minutes can rapidly evaporate following trades in away markets.¹⁵ The Exchanges assert that, because DMMs do not have the ability to direct or influence trading or to control intra-day prices that specialists had before the implementation of Regulation NMS, the Prohibited Transactions Rule is anachronistic.¹⁶

III. Summary of Comment Letter and the Exchanges’ Response

The Commission received one comment letter in support of the NYSE proposal and a combined response letter from NYSE and NYSE MKT.¹⁷ The commenter asserts that the Prohibited Transactions Rule is no longer necessary. First, the commenter states that, when the

¹⁴ See NYSE Notice, supra note 4, 81 FR at 81223; NYSE MKT Notice, supra note 4, 81 FR at 81211.

¹⁵ See id.

¹⁶ See id.

¹⁷ See supra note 7. While Citadel submitted its letter solely to the NYSE proposal, the Commission will consider the comment letter to be applicable to the NYSE MKT proposal, as both proposals are substantively identical.

Prohibited Transactions Rule was originally adopted, structural advantages enjoyed by NYSE specialists—including a dominant position in NYSE-listed securities and an advance look at incoming orders—warranted imposing prescriptive limitations on their trading activities, particularly at certain critical pricing points during the day, such as the pre-closing period.¹⁸ The commenter states that, because DMMs no longer have these same structural advantages, and because DMMs do not have the dominant position that NYSE specialists once had in the trading of NYSE-listed securities, DMMs should be able to engage in the sorts of transactions barred under the Prohibited Transactions Rule.¹⁹

Second, the commenter states that the Prohibited Transactions Rule is unnecessary because existing NYSE and Commission rules “prohibit all market participants, including DMMs, from engaging in market manipulation, including around the close.”²⁰ Finally, the commenter states that the Prohibited Transactions Rule is “artificial” and creates an “uneven playing field” in the current market structure because it only prohibits trading activity on a single exchange.²¹ According to the commenter, this restriction affects a DMM’s ability to provide competitive quotations during the last ten minutes of trading, thereby hindering price discovery,

¹⁸ See Citadel Letter, supra note 7, at 1–3.

¹⁹ See id. The commenter states that, for example, in February 2017, NYSE market share for NYSE-listed stocks was approximately 24% including auctions and 19% excluding auctions. See id. at 2. The commenter further states that, during the same month, a stock in which NYSE is the primary exchange and the DMM is the commenter, NYSE market share during the last ten minutes was approximately 27% on a share-weighted basis. See id.

²⁰ Id. at 3.

²¹ See id. at 3–4.

reducing liquidity at NYSE, and causing trading activity to migrate to venues where participants are not subject to the same artificial restriction.²²

According to NYSE and NYSE MKT, in today's electronic marketplace, where increased automation of trading has decentralized control of pricing decisions away from the DMM and from other market participants on the Exchanges' trading floor, retaining the Prohibited Transactions Rule is no longer necessary.²³ NYSE and NYSE MKT believe that the Prohibited Transactions Rule is anachronistic because DMMs do not have the same ability to direct or influence trading or control intra-day prices that specialists had before Regulation NMS.²⁴ Further, NYSE and NYSE MKT assert that the proposal does not alter the existing balance of DMM benefits and obligations because, despite the elimination of the Prohibited Transactions Rule, remaining DMM obligations would be sufficient to safeguard against the possibility that DMMs may act to inappropriately influence prices or manipulate the close.²⁵ Finally, NYSE and NYSE MKT state that the Exchanges would use their existing suite of trading surveillances to assess whether a particular transaction was effectuated to manipulate a security's price going into the close to benefit the DMM's position.²⁶

²² See id.

²³ See NYSE Letter, supra note 7, at 3.

²⁴ See id.

²⁵ See id. at 3–6. The Exchanges state that these obligations include the obligations: (1) not to destabilize the market when buying or selling to increase a position or reaching across the market; (2) to facilitate the close; (3) to effect transactions in a reasonable and orderly manner; and (4) to refrain from causing or exacerbating excessive price movements. See id.

²⁶ See id. at 5.

IV. Discussion and Commission Findings

Under Section 19(b)(2)(C) of the Exchange Act,²⁷ the Commission shall approve a proposed rule change by a self-regulatory organization if the Commission finds that the proposed rule change is consistent with the requirements of the Exchange Act and the applicable rules and regulations thereunder.²⁸ The Commission shall disapprove a proposed rule change if it does not make such a finding.²⁹ The Commission's Rules of Practice, under Rule 700(b)(3), state that the "burden to demonstrate that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder ... is on the self-regulatory organization that proposed the rule change" and that a "mere assertion that the proposed rule change is consistent with those requirements ... is not sufficient."³⁰

After careful consideration of the proposals, and for the reasons discussed below, the Commission does not believe that the proposed rule changes are consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities exchange.³¹ Specifically, the Commission does not find that the proposals are consistent with Section 6(b)(5) of the Exchange Act, which, among other things, requires that the rules of a

²⁷ 15 U.S.C. 78s(b)(2)(C).

²⁸ See 15 U.S.C. 78s(b)(2)(C)(i).

²⁹ See 15 U.S.C. 78s(b)(2)(C)(ii).

³⁰ 17 CFR 201.700(b)(3). The description of a proposed rule change, its purpose and operation, its effect, and a legal analysis of its consistency with applicable requirements must all be sufficiently detailed and specific to support an affirmative Commission finding. See id. Any failure of a self-regulatory organization to provide the information elicited by Form 19b-4 may result in the Commission not having a sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder that are applicable to the self-regulatory organization. See id.

³¹ In disapproving the proposed rule changes, the Commission has considered the proposed rules' impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

national securities exchange not be designed to permit unfair discrimination and that those rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest.³²

The Exchanges propose to eliminate the Prohibited Transactions Rule—a negative obligation imposed on DMMs to restrict aggressive trading immediately before the close—and the Commission analyzes the proposed rule changes in the context of the unique role played by DMMs on the Exchanges. Because the Exchanges’ proposal would alter the balance of the benefits and obligations of DMMs, and in light of the special responsibilities that DMMs have for the closing auction on the Exchanges, the Commission sought comment in the Orders Instituting Proceedings on these topics. Specifically, the Commission asked for public comment on whether each Exchange’s proposal “would maintain an appropriate balance between the benefits and obligations of being a DMM on the Exchange and whether the obligations of DMMs under remaining Exchange rules are reasonably designed to prevent DMMs from inappropriately influencing or manipulating the close in light of DMMs’ special responsibility for closing auctions under Exchange rules.”³³

The Prohibited Transactions Rule was originally adopted by NYSE in 2006 as NYSE moved to its “hybrid market” model,³⁴ and NYSE retained Prohibited Transactions Rule in 2008,

³² See 15 U.S.C. 78f(b)(5).

³³ NYSE Order Instituting Proceedings, supra note 6, 82 FR at 11389; NYSE MKT Order Instituting Proceedings, supra note 6, 82 FR at 11380.

³⁴ See Securities Exchange Act Release No. 54860 (Dec. 1, 2006), 71 FR 71221 (Dec. 8, 2006) (SR-NYSE-2006-76) (order approving amendments to Rule 104 that included Prohibited Transactions in Supplementary Material .10 of Rule 104).

when it adopted its New Market Model, which replaced the specialists on its floor with DMMs.³⁵ NYSE MKT subsequently adopted the NYSE's New Market Model, including the Prohibited Transactions Rule, pursuant to its merger with the NYSE.³⁶

Exchange Rule 104 sets forth the obligations of DMMs on each Exchange, which include the affirmative obligation to engage in a course of dealings for their own account to assist in the maintenance of a fair and orderly market in securities for which they have been assigned responsibility as the DMM, to maintain quotes in their assigned securities at the inside market a specified percentage of time, and to facilitate certain transactions in their assigned securities, most notably the opening and closing auctions.³⁷ Under Exchange rules, DMMs have significant responsibilities to “facilitate the close of trading” in their assigned securities.³⁸ The closing price for a security on its listing exchange is widely used as a reference price (e.g., by mutual funds calculating their net asset value), and the listing exchange tends to have a dominant market share at the close.³⁹

Supporting these general obligations, Exchange Rules 104(g) and 104(h) regulate specific types of DMM transactions: Neutral Transactions, Non-Conditional Transactions, Conditional

³⁵ See Securities Exchange Act Release No. 58845 (Oct. 24, 2008), 73 FR 64379 (Oct. 29, 2008) (SR-NYSE-2008-46) (order approving New Market Model pilot program).

³⁶ See Securities Exchange Act Release No. 75952 (Sept. 18, 2015), 80 FR 57645, 57646 & n.6 (Sept. 24, 2015) (describing filings by which NYSE MKT adopted NYSE equity trading rules).

³⁷ See Exchange Rule 104.

³⁸ See Exchange Rule 104; NYSE Rule 123C; NYSE MKT Rule 123C – Equities.

³⁹ See, e.g., NYSE Opening and Closing Auctions Fact Sheet (stating that NYSE has a 100% market share in the closing auction for Tape A securities), https://www.nyse.com/publicdocs/nyse/markets/nyse/NYSE_Opening_and_Closing_Auctions_Fact_Sheet.pdf.

Transactions, and Prohibited Transactions.⁴⁰ DMMs may engage in Conditional Transactions throughout the trading day—generally, crossing the market to take liquidity by buying (selling) at an increasing (decreasing) price—if those transactions are followed by “appropriate” re-entry on the opposite side of the market “commensurate with the size of the DMM’s transaction.”⁴¹ During the last ten minutes of the day, however, DMMs are subject to the Prohibited Transactions Rule at issue here—a bright-line rule against aggressively taking liquidity and moving prices on the exchange immediately before the closing auction.⁴²

In return for their obligations and responsibilities, DMMs have significant priority and informational advantages in trading on the Exchanges, both during continuous trading and during the closing auction. During continuous trading, DMMs trade on parity with the entire order book

⁴⁰ See Exchange Rule 104(g)(i)(A)(I)–(III) (defining Neutral Transactions, Non-Conditional Transactions, and Prohibited Transactions); Exchange Rule 104(h)(i) (defining Conditional Transaction). A Neutral Transaction is a purchase or sale by which a DMM liquidates or decreases a position and may be made without regard to price, but the DMM’s “obligation to maintain a fair and orderly market may require re-entry on the opposite side of the market trend ... in accordance with the immediate and anticipated needs of the market.” See Exchange Rule 104(g)(i)(A)(I). A Non-Conditional Transaction is a DMM’s bid or purchase and offer or sale that establishes or increases a position, other than a transaction that reaches across the market to trade with the Exchange best bid or offer, and may be made without regard to price in order to match another market’s better bid or offer price; to bring the price of a security into parity with an underlying or related security or asset; to add size to an independently established bid or offer on the Exchange; to purchase at the published bid price on the Exchange; to sell at the published offer price on the Exchange; to purchase or sell at a price between the Exchange BBO; or to purchase below the published bid or sell above the published offer on the Exchange. See Exchange Rule 104(g)(i)(A)(II). Following a Non-Conditional Transaction, a DMM’s obligation to maintain a fair and orderly market “may require re-entry on the opposite side of the market trend ... commensurate with the size of the Non-Conditional Transactions and the immediate and anticipated needs of the market.” *Id.*

⁴¹ See Exchange Rule 104(h)(i)–(iv). According to their rules, the Exchanges periodically issue guidelines, called “price participation points” that “identify the price at or before which a DMM is expended to re-enter the market after effecting a Conditional Transaction.” See Exchange Rule 104(h)(iii)(A).

⁴² See Exchange Rule 104(g)(i)(A)(III).

and with floor brokers, which “provides DMMs with a substantial advantage over off-Floor orders” sent to the NYSE order book.⁴³ Moreover, during the trading day, including the ten minutes before the close, DMMs have unique access to aggregated information about closing auction interest at each price level, and, during the auction itself, DMMs are aware of interest represented by floor brokers, which is not publicly disseminated.⁴⁴ When offsetting an imbalance during the closing auction, DMM interest trades at parity with limit orders on the Exchange order book, and DMM interest takes priority over limit-on-close orders with a price equal to the closing price and over closing-offset orders.⁴⁵ In approving the entire set of advantages given to DMMs in 2008 through the New Market Model, the Commission specifically assessed “whether the rewards granted to DMMs ... are commensurate with their obligations” and found that the proposed New Market Model pilot reflected “an appropriate balance of DMM obligations against the benefits provided to DMMs.”⁴⁶

In proposing to remove the Prohibited Transactions Rule, however, NYSE and NYSE MKT have failed to adequately explain or justify how the proposed alteration to the balance of benefits and obligations of a DMM previously approved by the Commission is consistent with Section 6(b)(5) of the Exchange Act, or how allowing DMMs to aggressively take liquidity in

⁴³ See Securities Exchange Act Release No. 58845 (Oct. 24, 2008), 73 FR 64379, 64389 (Oct. 29, 2008) (Order approving SR-NYSE-2008-46). See also NYSE Rule 72(c)(ii) and NYSE MKT Rule 72(c)(ii) – Equities (stating that, for the purpose of share allocation in an execution, each single floor broker, the DMM, and orders on the Exchange book shall constitute individual participants and that the orders on the Exchange book shall constitute a single participant).

⁴⁴ See Exchange Rule 104(j); see also NYSE Rule 123C and NYSE MKT Rule 123C – Equities.

⁴⁵ See NYSE Rule 123C(7)(b); NYSE MKT Rule 123C(7)(b) – Equities.

⁴⁶ Securities Exchange Act Release No. 58845 (Oct. 24, 2008), 73 FR 64379, 64388–89 (Oct. 29, 2008) (SR-NYSE-2008-46).

the last ten minutes of trading is both consistent with a DMM's obligation to maintain a fair and orderly market in its assigned securities and designed to prevent fraudulent or manipulative acts and practices regarding the closing auction, for which a DMM has crucial responsibilities.

The Exchanges and Citadel in their comment letters argue that changes in market structure such as the inability of DMMs, compared to specialists, to “set prices” in their assigned securities, and the movement of trading volume in NYSE-listed securities away from the NYSE, support the elimination of the Prohibited Transactions Rule. But, as noted above, the Prohibited Transactions Rule was included in the New Market Model rule filing that established the role of DMMs, and the market-share statistics offered by Citadel—which purportedly establish the relatively weak pricing power of a DMM⁴⁷—fail to acknowledge that the Exchanges have a dominant market share in the closing auction,⁴⁸ and that a DMM has discretion and informational advantages that place the DMM in a unique position to choose its own level of participation in the auction and to influence the closing price.⁴⁹ Additionally, the argument by Citadel that the current prohibition creates an uneven playing field, and that it limits DMMs’ “ability to provide competitive quotations,”⁵⁰ fails to address that DMMs have unique privileges on NYSE and NYSE MKT and that the proposed rule change is not limited to circumstances in which DMMs would be allowed to quote competitively and provide liquidity, but would also allow them to aggressively take liquidity.

⁴⁷ See Citadel Letter, supra note 7, at 2.

⁴⁸ See supra note 39 and accompanying text.

⁴⁹ See supra notes 42–44 and accompanying text.

⁵⁰ Citadel Letter, supra note 7, at 2–3.

Additionally, while NYSE and NYSE MKT have argued that the proposal is consistent with the Exchange Act because remaining exchange rules address the possibility of disruptive or improper DMM trading during the last ten minutes of the day, the Commission does not believe that NYSE and NYSE MKT have met their burden to demonstrate that these other rules—which require the exercise of judgment as to what is “reasonable,” “excessive,” “appropriate,” or “commensurate”⁵¹—are adequate substitutes for a clear, meaningful, and enforceable bright-line rule that limits aggressive DMM trading at a particularly sensitive and important time of the trading day and that addresses the risk of destabilizing or even manipulative activity. Additionally, the Commission believes that NYSE and NYSE MKT have merely asserted that, but not explained how, existing surveillances can act as an adequate substitute for this bright-line rule.

Thus, because the Exchanges’ arguments in favor of the proposed rule changes do not adequately address significant issues raised by the proposals, the Commission does not find that the proposed rule changes are consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities exchange and, in particular, with Section 6(b)(5) of the Exchange Act.

⁵¹ See supra notes 25 & 40 and accompanying text.

V. Conclusion

IT IS THEREFORE ORDERED THAT, pursuant to Section 19(b)(2) of the Exchange Act,⁵² the proposed rule changes (SR-NYSE-2016-71 and SR-NYSEMKT-2016-99) be, and hereby are, DISAPPROVED.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁵³

Jill M. Peterson
Assistant Secretary

⁵² 15 U.S.C. 78s(b)(2).

⁵³ 17 CFR 200.30-3(a)(12).