

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-74210; File No. SR-BOX-2014-28)

February 5, 2015

Self-Regulatory Organizations; BOX Options Exchange LLC; Order Approving Proposed Rule Change Adopt BOX Rule 7300 to Allow the Exchange to Trade Preferred Orders

I. Introduction

On December 8, 2014, BOX Options Exchange LLC (“BOX” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change 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> to permit BOX Options Participants (“Participants”) to submit orders for which a Market Maker is designated to receive an Preferred allocation on the Exchange (“Preferred Orders”). The proposed rule change was published in the Federal Register on December 24, 2014.<sup>3</sup> This order approves the proposed rule change.

II. Description of the Proposed Rule Change

As described in more detail below, the Exchange proposes to adopt new BOX Rule 7300 to establish a program that will permit Participants to submit Preferred Orders to Market Makers and for Market Makers to receive Preferred allocations on such orders.<sup>4</sup> As proposed, a Preferred Order is any order, whether on a single options instrument or on a Complex Order Strategy, for which a Preferred Market Maker is designated with respect to such order, upon

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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. 73878 (December 18, 2014), 79 FR 77579 (“Notice”).

<sup>4</sup> See Notice, supra note 3 at 77579.

submission of such order to BOX.<sup>5</sup> A Preferred Market Maker is a Market Maker designated as such by a Participant with respect to an order submitted by such Participant to BOX.<sup>6</sup>

All order types and designations available on BOX will be eligible to be entered as Preferred Orders, except for Customer Cross Orders (which do not involve market makers) and Directed Orders (which relate to BOX's PIP and COPIP matching algorithms).<sup>7</sup>

Preferred Orders will be treated the same as other orders submitted to the Exchange, including being executed in price/time priority in accordance with the existing matching algorithm on the Exchange,<sup>8</sup> with some exceptions as described below and in proposed Rule 7300.<sup>9</sup> Although Complex Orders may be submitted as Preferred Orders, such orders will be given the same treatment as Complex Orders submitted without designation.<sup>10</sup>

Proposed BOX Rule 7300(c)(2) requires that a Preferred Market Maker maintain a continuous two-sided market, pursuant to BOX Rule 8050(c)(1), throughout the trading day, in options classes for which it accepts Preferred Orders, for 99% of the time the Exchange is open for trading in each such option class.<sup>11</sup> However, a Preferred Market Maker will not be required to quote in intra-day add-on series or series that have an expiration of nine months or greater in the classes for which it receives Preferred Orders.<sup>12</sup>

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<sup>5</sup> Proposed BOX Rule 7300(a)(1).

<sup>6</sup> Proposed BOX Rule 7300(a)(2).

<sup>7</sup> Proposed BOX Rule 7300(d).

<sup>8</sup> See Notice, supra note 3 at 77579.

<sup>9</sup> Proposed BOX Rule 7300(b).

<sup>10</sup> See Notice, supra note 3 at 77581.

<sup>11</sup> Proposed BOX Rule 7300(a)(2).

<sup>12</sup> Id. Compliance with this requirement will be determined on a monthly basis, however, this does not relieve a Preferred Market Maker from meeting the quoting requirement on a daily basis, nor does it prohibit the Exchange from taking disciplinary action against a

## Preferred Allocation

Pursuant to proposed BOX Rule 7300(c), when the total quantity of all orders available for execution on the Exchange against a Preferred Order on a single options series is less than or equal to the executable quantity of the Preferred Order at a given price level, all such orders at that price will be filled and the balance of the Preferred Order, if any, will be executed, if possible, against orders at the next best price level.<sup>13</sup> At the final price level, where the remaining quantity of the Preferred Order is less than the total quantity of orders on the Exchange available for execution, and after all Public Customer orders have been filled, the Preferred Market Maker will receive a Preferred allocation set forth below, provided that: (1) the price level is at the NBBO, (2) the Preferred Market Maker has an existing quote on the opposite side of the Preferred Order that is at the NBBO at the time the Preferred Order is received, and (3) the Preferred Market Maker would not receive an allocation greater than 40% if allocated according to the Exchange's normal price/time priority.<sup>14</sup>

The Preferred allocation will be limited by the total quantity of the Preferred Market Maker's quote and will be 40% of the remaining quantity of the Preferred Order after all Public Customer orders are filled, or 50% of the remaining quantity if only one other executable,

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Preferred Market Maker for failing to meet this requirement each trading day. The Exchange will determine compliance with these obligations on a monthly basis. Id.

If a technical failure or limitation of a system of the Exchange prevents a Market Maker from maintaining, or prevents a Market Maker from communicating to the Exchange, timely and accurate electronic quotes in an issue, the duration of such failure shall not be considered in determining whether the Market Maker has satisfied its quoting obligation. The Exchange may consider other exceptions to this obligation based on a demonstrated legal or regulatory requirement or other mitigating circumstances. Id.

<sup>13</sup> Proposed BOX Rule 7300(c).

<sup>14</sup> Proposed BOX Rule 7300(c)(2).

non-Public Customer order matches the Preferred Order at the final price level.<sup>15</sup> Under the Exchange's proposal, Legging Orders will not be considered when determining whether the Preferred Market Maker receives its 40% or 50% allocation.<sup>16</sup>

Once the Preferred Order is allocated to the Preferred Market Maker, or if no Preferred Allocation is made, BOX will distribute any remaining unallocated quantity of the Preferred Order to all remaining orders and quotes, not including any Legging Order, that have not already received an allocation.<sup>17</sup> This includes any quote by a Preferred Market Maker if no Preferred allocation was previously made. Allocations will be made in order of time priority. Following the allocation of all remaining order and quotes described above, any remaining unallocated quantity of the Preferred Order will be allocated to any Legging Order at the same price.<sup>18</sup>

### III. Discussion and Commission Findings

The Commission has carefully reviewed the proposed rule change and finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>19</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 6(b) of the Act,<sup>20</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act.<sup>21</sup> Section 6(b)(5) requires, among other things, that the rules of the national securities exchange be designed to prevent fraudulent and manipulative acts

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<sup>15</sup> Proposed BOX Rule 7300(c)(2); See Notice, supra note 3 at 77580.

<sup>16</sup> Proposed BOX Rule 7300(c)(2).

<sup>17</sup> Proposed BOX Rule 7300(c)(3).

<sup>18</sup> Proposed BOX Rule 7300(c)(4).

<sup>19</sup> 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).

<sup>20</sup> 15 U.S.C. 78f(b).

<sup>21</sup> 15 U.S.C. 78f(b)(5).

and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.

The Commission has previously approved rules of other national securities exchanges that provide for enhanced participation guarantees.<sup>22</sup> The Commission has closely scrutinized such exchange rule proposals where the percentage of enhanced participation would rise to a level that could have a material adverse impact on quote competition within a particular exchange.<sup>23</sup>

BOX's proposal to permit Preferred Market Makers to receive a 40% allocation (or 50% where there is only one other non-public customer order at the same price as the Preferred Order) will not increase the overall percentage of an order that is guaranteed to the Preferred Market Maker beyond the currently acceptable threshold.<sup>24</sup> Under the proposal, the remaining portion of each order will be available for allocation based on the competitive bidding of market

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<sup>22</sup> See Securities Exchange Act Release No. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (SR-Phlx-2004-91) ("Phlx Order"); see also e.g., Securities Exchange Act Release Nos. 47628 (April 3, 2003), 68 FR 17697 (April 10, 2003) (SR-CBOE-00-55) ("CBOE Order"); 52331 (August 24, 2005), 70 FR 51856 (August 31, 2005) (SR-ISE-2004-16) ("ISE Order"); 52506 (September 23, 2005), 70 FR 57340 (September 30, 2005) (SR-CBOE-2005-58); 59472 (February 27, 2009) 74 FR 9843 (March 6, 2009) (SRNYSEALTR-2008-14) ("NYSEALTR Order"); 60469 (August 10, 2009), 74 FR 41478 (August 17, 2009) (SR-NYSEArca-2009-73) ("NYSE Arca Notice"); 68070 (October 18, 2012), 77 FR 65037 (October 18, 2012) (SR-C2-2012-24) ("C2 Order"); and 74129 (January 23, 2015), 80 FR 4954 (January 29, 2015) ("BX Order").

<sup>23</sup> See Phlx Order, *supra* note 22 at 32861.

<sup>24</sup> *Id.* See also CBOE Order, *supra* note 22 at 17708 (citing Securities Exchange Act Release No. 45936 (May 15, 2002), 67 FR 36279, 26280 (May 23, 2002); Securities Exchange Act Release No. 42835 (May 26, 2000), 65 FR 35683, 35685–66 (June 5, 2000); Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388, 11398 (March 2, 2000); Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48778, 48787–88 (August 9, 2000)).

participants. Therefore, the Commission does not believe that the proposal will negatively impact quote competition or order flow on BOX.

A Preferred Market Maker will have to be quoting at, or better than, the NBBO at the time a Preferred Order is received in order to obtain the 40% or 50% guarantee. The Commission believes that it is critical that a Preferred Market Maker must not be permitted to step up and match the NBBO after it receives a directed order in order to receive the Preferred Allocation. In this regard, BOX's proposal prohibits notifying a DMM of an intention to submit a Directed Order so that such DMM could change its quotation to match the NBBO immediately prior to submission of the Directed Order, and then fade its quote. BOX submitted a letter to the Commission representing that it will provide the necessary protections against that type of conduct, and will proactively conduct surveillance for, and enforce against, such violations.<sup>25</sup>

BOX's proposed rules will require Preferred Market Makers to quote at a higher level than other market makers who are not Preferred Market Makers. Currently, market makers on BOX are required to quote 60% of the trading day.<sup>26</sup> In order to receive the participation entitlement, Preferred Market Makers will be required to quote 99% of the trading day. The Commission believes that requiring heightened quoting by a market maker in order to be eligible to receive a Preferred Allocation is consistent with what other exchanges have required as part of their directed order programs.<sup>27</sup>

The Commission emphasizes that approval of this proposal does not affect a broker-dealer's duty of best execution. A broker-dealer has a legal duty to seek to obtain best execution

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<sup>25</sup> See Letter from Bruce Goodhue, Chief Regulatory Officer, BOX, to David Hsu, Assistant Director, Commission, dated February 4, 2015.

<sup>26</sup> BOX Rule 8050(e).

<sup>27</sup> See supra note 22.

of customer orders, and any decision to preference a particular Preferred Market Maker must be consistent with this duty.<sup>28</sup> A broker-dealer's duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated in SRO rules and, through judicial and Commission decisions, the antifraud provisions of the federal securities laws.<sup>29</sup> The duty of best execution requires broker-dealers to execute customers' trades at the most favorable terms reasonably available under the circumstances, *i.e.*, at the best reasonably available price.<sup>30</sup> The duty of best execution requires broker-dealers to periodically assess the quality of competing

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<sup>28</sup> See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 269-70, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998); Certain Market Making Activities on Nasdaq, Securities Exchange Act Release No. 40900 (Jan. 11, 1999) (settled case) (citing Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971); Arleen Hughes, 27 SEC 629, 636 (1948), aff'd sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949)). See also Order Execution Obligations, Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) ("Order Handling Rules Release"); 51808 (June 9, 2005), 70 FR 37496, 37537-8 (June 29, 2005).

<sup>29</sup> Order Handling Rules Release, *supra* note 28 at 48322. See also Newton, 135 F.3d at 270. Failure to satisfy the duty of best execution can constitute fraud because a broker-dealer, in agreeing to execute a customer's order, makes an implied representation that it will execute it in a manner that maximizes the customer's economic gain in the transaction. See Newton, 135 F.3d at 273 ("[T]he basis for the duty of best execution is the mutual understanding that the client is engaging in the trade – and retaining the services of the broker as his agent – solely for the purpose of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal."); Marc N. Geman, Securities Exchange Act Release No. 43963 (Feb. 14, 2001) (citing Newton, but concluding that respondent fulfilled his duty of best execution). See also Payment for Order Flow, Securities Exchange Act Release No. 34902 (Oct. 27, 1994), 59 FR 55006, 55009 (Nov. 2, 1994) ("Payment for Order Flow Final Rules"). If the broker-dealer intends not to act in a manner that maximizes the customer's benefit when he accepts the order and does not disclose this to the customer, the broker-dealer's implied representation is false. See Newton, 135 F.3d at 273-274.

<sup>30</sup> Newton, 135 F.3d at 270. Newton also noted certain factors relevant to best execution - order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. *Id.* at 270 n. 2 (citing Payment for Order Flow, Securities Exchange Act Release No. 33026 (Oct. 6, 1993), 58 FR 52934, 52937-38 (Oct. 13, 1993) (Proposed Rules)). See In re E.F. Hutton & Co., Securities Exchange Act Release No. 25887 (July 6, 1988). See also Payment for Order Flow Final Rules, 59 FR at 55008-55009.

markets to assure that order flow is directed to the markets providing the most beneficial terms for their customer orders.<sup>31</sup> Broker-dealers must examine their procedures for seeking to obtain best execution in light of market and technology changes and modify those practices if necessary to enable their customers to obtain the best reasonably available prices.<sup>32</sup> In doing so, broker-dealers must take into account price improvement opportunities, and whether different markets may be more suitable for different types of orders or particular securities.<sup>33</sup>

For these reasons, the Commission believes that the proposal is consistent with the requirements of Section 6(b)(5) of the Act.<sup>34</sup>

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<sup>31</sup> Order Handling Rules Release, supra note 28 48322-48333 (“In conducting the requisite evaluation of its internal order handling procedures, a broker-dealer must regularly and rigorously examine execution quality likely to be obtained from different markets or market makers trading a security.”). See also Newton, 135 F.3d at 271; Market 2000: An Examination of Current Equity Market Developments V-4 (SEC Division of Market Regulation January 1994) (“Without specific instructions from a customer, however, a broker-dealer should periodically assess the quality of competing markets to ensure that its order flow is directed to markets providing the most advantageous terms for the customer’s order.”); Payment for Order Flow Final Rules, 59 FR at 55009.

<sup>32</sup> Order Handling Rules, supra note 28 at 48323.

<sup>33</sup> Order Handling Rules, supra note 28 at 48323. For example, in connection with orders that are to be executed at a market opening price, “[b]roker-dealers are subject to a best execution duty in executing customer orders at the opening, and should take into account the alternative methods in determining how to obtain best execution for their customer orders.” Disclosure of Order Execution and Routing Practices, Securities Exchange Act Release No. 43590 (Nov.17, 2000), 65 FR 75414, 75422 (Dec. 1, 2000) (adopting new Exchange Act Rules 11Ac1-5 and 11Ac1-6 and noting that alternative methods offered by some Nasdaq market centers for pre-open orders included the mid-point of the spread or at the bid or offer).

<sup>34</sup> 15 U.S.C. 78f(b)(5).



IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>35</sup> that the proposed rule change (SR-BOX-2014-28) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>36</sup>

Brent J. Fields  
Secretary

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<sup>35</sup> 15 U.S.C. 78s(b)(2).

<sup>36</sup> 17 CFR 200.30-3(a)(12).