

September 23, 2011

Self-Regulatory Organizations; NASDAQ OMX BX, Inc.; Order Approving Proposed Rule Change Amending Chapter V, Section 31 of the Rules of the Boston Options Exchange Group, LLC to Establish Facilitation and Solicitation Auction Mechanisms

I. Introduction

On June 17, 2011, NASDAQ OMX BX, Inc. (“BX” or “Exchange”) 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 amend Chapter V (Doing Business on BOX), Section 31 (Block Trading) of the Rules of the Boston Options Exchange Group, LLC (“BOX”), to establish facilitation and solicitation auction mechanisms. The proposed rule change was published for comment in the Federal Register on June 29, 2011.³ The Commission received no comments on the proposal. This order approves the proposed rule change.

II. Description of the Proposal

Facilitation Auction—The Facilitation Auction will allow Order Flow Providers (“OFPs”) on BOX to enter crossing transactions in which an OFP represents, as agent, an order (“Agency Order”) of 50 contracts or more and (a) is trading against the Agency Order as principal, and/or (b) has solicited an order to take the opposite side of the Agency Order. To utilize the Facilitation Auction, an OFP must be willing to execute the entire size of the Agency Order through the submission of a contra “Facilitation Order.”

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 64734 (June 23, 2011), 76 FR 38226 (“Notice”).

Upon the entry of an Agency Order and Facilitation Order into the Facilitation Auction, a broadcast message, which will include the proposed execution price of the cross (the 'Facilitation Price'), will be sent to Options Participants giving them one second to enter responses ('Responses')⁴ with the prices and sizes at which they would be willing to participate in the facilitation opposite the Agency Order. At the end of the one second period for the entry of Responses, the Agency Order will be automatically executed, as follows:

Unless there is sufficient size to execute the entire Agency Order at a price better than the Facilitation Price, Public Customer bids (offers) and Public Customer Responses on BOX at the time the Agency Order is executed that are priced higher (lower) than the Facilitation Price will be executed at the facilitation price. Non-Public Customer and Market Maker bids (offers) and Non-Public Customer and Market Maker Responses on BOX at the time the Agency Order is executed that are priced higher (lower) than the Facilitation Price will be executed against the Agency Order at their stated price.

The facilitating OFP will execute at least forty percent of the original size of the Facilitation Order, but only after better-priced bids (offers) and Responses on BOX, as well as Public Customer bids (offers) and Responses at the facilitation price, are executed in full. After the facilitating OFP has executed its forty percent, Non-Public Customer and Market Maker bids (offers) and Responses on BOX at the Facilitation Price will participate in the execution of the Agency Order based upon price and time priority.⁵

Solicitation Auction—The Solicitation Auction will allow OFPs to attempt to execute Agency Orders of 500 or more contracts against contra orders that the OFP has solicited

⁴ Responses are permitted to be entered on behalf of any customer.

⁵ The Exchange provided a more detailed explanation regarding the Facilitation Auction in the Notice. See Notice, supra note 3.

(‘Solicited Orders’).⁶ Executions will occur only if the price is at or between the national best bid or offer (‘NBBO’). Each Agency Order entered into the Solicitation Auction must be an all-or-none order.

When a proposed solicited cross is entered into the Solicitation Auction, BOX will broadcast a message, which will include the proposed execution price of the cross, to Options Participants, and they will have one second to enter Responses with the prices and sizes at which they would be willing to participate in the execution of the Agency Order. At the end of the one second period for the entry of Responses, the Agency Order will be automatically executed in full or cancelled.

The Agency Order will be executed against the Solicited Order at the proposed execution price unless (a) there is sufficient size to execute the entire Agency Order at a better price or prices, or (b) there is a Public Customer order resting on the BOX Book at a price equal to or better than the proposed execution price within the depth of the BOX Book that would have traded with the Agency Order if the Agency Order had been submitted to the BOX Book instead of to the mechanism (a ‘Book Priority Public Customer Order’).⁷

If there is sufficient size to execute the entire Agency Order at a better price or prices at the time of execution, the Agency Order will be executed at the improved price(s) and the Solicited Order will be cancelled. The aggregate size of all bids (offers) and Responses at each price will be used to determine whether the entire Agency Order can be executed at an improved price (or prices).⁸

⁶ The Exchange provided a more detailed explanation of how the Solicitation Auction will work, with examples, in the Notice. See Notice, supra note 3.

⁷ See Chapter V, Section 31(b)(ii)(1) of the BOX Rules.

⁸ See Chapter V, Section 31(b)(ii)(3) of the BOX Rules.

If there is not sufficient size to execute the entire Agency Order at a better price or prices, whether the Agency Order will be executed against the Solicited Order at the proposed execution price depends on whether there is one or more Book Priority Public Customer Order(s) on the BOX Book at the time of execution. If no such Book Priority Public Customer Orders are on the BOX Book at the time of execution, the Agency Order will be executed against the Solicited Order at the proposed execution price.⁹ However, if there is one or more Book Priority Public Customer Orders on the Book, then BOX will calculate whether sufficient size exists to execute the Agency Order at its proposed price. In making this calculation, the Exchange will include the aggregate size of all bids (offers) on the BOX Book at or better than the proposed execution price but exclude Responses.¹⁰

After this calculation, if there is sufficient size available on the BOX Book, including non-public customer interest, to execute the entire Agency Order at the proposed price, the Agency Order will be executed against the BOX Book.¹¹ If there is not sufficient size available on the BOX Book, including non-public customer interest, to execute the entire Agency Order at the proposed price, the Agency Order and the Solicited Order will be cancelled and no executions will occur.¹²

⁹ See Chapter V, Section 31(b)(ii)(1) of the BOX Rules. In addition, the Agency Order will not be executed against the Solicited Order unless the execution price is equal to or better than the NBBO at the time of execution. If an execution would take place at a price that is inferior to the best bid or offer on BOX or the NBBO, both the Solicited Order and Agency Order will be cancelled. Id. Thus, a Solicited Order cannot trade through a better price on an away market or on the BOX Book.

¹⁰ See Chapter V, Section 31(b)(ii)(2) of the BOX Rules.

¹¹ Id.

¹² See Chapter V, Section 31(b)(ii)(1) of the BOX Rules.

BOX's Solicitation Auction proposal includes a "Surrender Quantity" function for Solicitation Auctions. An OFP may use this function when starting a Solicitation Auction by designating, for the Solicited Order, the quantity of contracts of the Agency Order for which the OFP is willing to "surrender" to the BOX Book ("Surrender Quantity"). In effect, the Surrender Quantity reduces the size of the Solicited Order in order to permit (a) Book Priority Public Customer Orders on the BOX Book at the proposed price or better, and/or (b) any bids (offers) on the BOX Book at any price better than the proposed execution price, to execute against the Agency Order.¹³ The surrender of contracts to the interest described in (a) and (b) of the prior sentence permits the Solicited Order to execute against the balance of contracts remaining in the Agency Order when otherwise the Solicited Order would not participate in the transaction at all or the Agency Order and Solicited Order both would be cancelled.

The following examples describe how a Solicitation Auction could be impacted by the presence of a Surrender Quantity:

- When a Book Priority Public Customer Order(s) is resting on the BOX Book at a price equal to or better than the proposed price, and, when aggregating all other interest on the BOX Book (i.e. including non-public customer interest but not including Responses), there is sufficient size to execute against the Agency Order at least at the proposed price, the Agency Order is executed against the BOX Book and the Solicited Order is cancelled.¹⁴ However, if the OFP has designated a Surrender Quantity, and the aggregate size of Book Priority Public Customer Orders, and other interest on the BOX Book at prices better than the proposed

¹³ See Chapter V, Section 31(b)(ii)(4) of the BOX Rules.

¹⁴ See supra notes 10-11 and accompanying text.

price, is equal to or less than the Surrender Quantity—i.e., such interest represents no more than the maximum quantity that the OFP is willing to surrender—the Agency Order will first execute against all such Book Priority Public Customer Orders and all other interest on the BOX Book at a better price,¹⁵ and then against the Solicited Order.

- When a Book Priority Public Customer Order(s) is resting on the BOX Book at a price equal to or better than the proposed execution price but there is otherwise insufficient quantity on the BOX Book to execute the entire Agency Order the Solicited Order is not permitted to bypass the Book Priority Public Customer(s) on the BOX Book, and both the Solicited Order and the Agency Order are cancelled.¹⁶ With the Surrender Quantity, however, the Book Priority Public Customer Order(s) will be executed first (assuming that it is not larger than the Surrender Quantity) and the remainder of the Agency Order will be executed against the Solicited Order.
- When the proposed execution price is inferior to the best bid or offer on the BOX Book, the Solicited Order is not permitted to trade through the better-priced

¹⁵ Public Customer bids (offers) on the BOX Book at the time of Surrender Quantity execution that are priced higher (lower) than the proposed execution price will be executed at the proposed execution price. Non-Public Customer and Market Maker bids (offers) on the BOX Book at the time of Surrender Quantity execution that are priced higher (lower) than the proposed execution price will be executed at their stated price, See Chapter V, Section 31(b)(ii)(4)(b) of the BOX Rules. The Surrender Quantity does not need to accommodate non-Public Customer interest at the proposed price, which would not, in itself, block a transaction with the Solicited Order. The Surrender Quantity also does not need to accommodate Responses even at a better price. (Responses at a better price are aggregated only to determine if the entire Agency Order can be executed at a better price.)

¹⁶ See supra note 12.

order(s) on the BOX Book, and both the Solicited Order and the Agency Order are cancelled.¹⁷ With the Surrender Quantity, however, the better priced order(s) on the BOX Book will be executed first (assuming that the size of such order(s) is not larger than the Surrender Quantity) and the remainder of the Agency Order will be executed against the Solicited Order.

The proposed rule change also will require OFPs to deliver to customers a written notification (in a form approved by the Exchange) describing the terms and conditions of the Solicitation Auction before executing Agency Orders using the Solicitation Auction.

Proposed Supplementary Material to Section 31 states that it will be a violation of an Options Participant's duty of best execution if it were to cancel a Facilitation Order to avoid execution of the order at a better price. Also, Options Participants will be prohibited from using the Solicitation Auction to circumvent Chapter V, Section 17, which limits principal transactions.¹⁸ Such prohibited actions may include, but are not limited to, Options Participants entering Solicitation Orders that are solicited from (i) affiliated broker-dealers, or (ii) broker-

¹⁷ See supra note 9.

¹⁸ As amended by the proposed rule change, Chapter V, Section 17, among other things, contains provisions that (a) prohibit an Options Participant from executing agency orders to increase its economic gain from trading against the order without first giving other trading interest; (b) provide that it will be a violation of the BOX Rules for an Options Participant to cause the execution of an order it represents as agent on BOX through the use of orders it solicited from Options Participants and/or non-Participant broker-dealers to transact with such orders, whether such solicited orders are entered into the BOX market directly by the Options Participant or by the solicited party (either directly or through another Participant), unless (i) the agency order is first exposed to the BOX Book for at least one (1) second, (ii) the Options Participant utilizes the Solicitation Auction, or (iii) the Options Participant utilizes the Price Improvement Period; and (c) provides that the agency order be first exposed to the BOX Book for at least one (1) second, (ii) the OFP has been bidding or offering on BOX for a least one (1) second prior to receiving an agency order that is executable against such bid or offer, (iii) the OFP sends the agency order to the Price Improvement Period or Universal Price Improvement Period, or (iv) the Options Participant utilizes the Solicitation Auction.

dealers with which the Options Participant has an arrangement that allows the Options Participant to realize similar economic benefits from the solicited transaction as it would achieve by executing the customer order in whole or in part as principal. Any Solicited Orders entered by Options Participants to trade against Agency Orders may not be for the account of a BOX market maker that is assigned to the options class.

In addition, the Supplementary Material provides that the proposed rule change will allow orders and Responses to be entered into the BOX Facilitation and Solicitation Auctions and receive executions at penny increments. Finally, the proposed rule change adds references to the Facilitation and Solicitation Auction mechanisms to Chapter V, Section 17 (Customer Orders and Order Flow Providers), and to Chapter III, Section 4(f) (Prevention of the Misuse of Material Nonpublic Information).

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.¹⁹ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b) of the Act,²⁰ in general, and Section 6(b)(5) of the Act,²¹ in particular, which requires that the rules of an exchange be designed, among other things, 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.

¹⁹ 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).

²⁰ 15 U.S.C. 78f(b).

²¹ 15 U.S.C. 78f(b)(5).

The Exchange's proposed Facilitation Auction is substantially similar to the facilitation mechanism currently operative at the International Securities Exchange, Inc. ("ISE"), which the Commission has found consistent with the Act.²² The Commission notes, however, that, on BOX, should any portion of Agency Order remain available for execution against Non-Public Customer and Market Maker bids (offers), such Non-Public Customer and Market Maker bids (offers) will be executed against the Agency Order on a price-time priority basis, instead of on a pro-rata priority basis, as is done on ISE. The use of price-time priority on BOX is consistent with the priority rules of BOX's trading system, whereas the use of pro-rata priority on ISE is consistent with the principles generally of that exchange. The Commission believes that this functionality is consistent with the Act.

The proposed Solicitation Auction on BOX also is modeled on similar mechanisms on other exchanges. The Commission previously has found such mechanisms consistent with the Act,²³ stating that they should allow for greater flexibility in pricing large-sized orders and may provide a greater opportunity for price improvement.²⁴ BOX has made certain modifications to its solicitation auction, in part to reflect its price-time priority system, and the Commission believes that these changes are also consistent with the Act.

The first modification relates to the interaction between Public Customer Orders and the Solicitation Auction. Specifically, in BOX's proposed Solicitation Auction, a Public Customer

²² See Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000)(concerning registration of the ISE, and, among other features of the exchange, the ISE's facilitation mechanism).

²³ See *id.*, and see Securities Exchange Act Release Nos. 49141(January 28, 2004), 69 FR 5625 (February 5, 2004) (SR-ISE-2001-22) (approval of ISE Solicited Order Mechanism) and 57610 (April 3, 2008), 73 FR 19535 (April 10, 2008) (SR-CBOE-2008-14) (approval of CBOE Solicitation Auction Mechanism).

²⁴ See Securities Exchange Act Release No. 57610 (April 3, 2008), 73 FR 19535 (April 10, 2008) (File No. SR-CBOE-2008-14).

Order resting on the BOX Book within the depth that would have traded with the Agency Order had the Solicitation Auction not been in place (i.e., a Book Priority Public Customer Order) would prevent the Solicited Order from executing against the Agency Order, while a Public Customer Order resting on the BOX Book below a depth that would be traded with the Agency Order had the Solicitation Auction not been in place (i.e., a public customer order that is not a Book Priority Public Customer Order) would not prevent such execution. Similar to ISEs solicitation mechanism, BOX's Solicitation Auction will not permit Public Customer orders to be bypassed, but, unlike ISEs mechanism, BOX's Solicitation Auction will only preclude the bypassing of Public Customers orders to the extent that such orders would have been entitled to participate in the execution of the Agency Order had the Agency Order been sent to the BOX Book.²⁵

The differential treatment of Public Customers orders that are not Book Priority Public Customer Orders and Book Priority Public Customer Orders is consistent with the price-time priority structure of the BOX market.²⁶ In particular, Public Customer orders that are not Book Priority Public Customer Orders would not have been executed against the Agency Order had it been sent to the BOX Book. Thus, the Commission believes that it is reasonable for BOX and consistent with the Act not to provide for the execution of such orders against the Agency Order and not to allow such orders to prevent the execution of a Solicited Order with an Agency Order.

The second modification relates to how Responses are aggregated with orders on the BOX Book. Specifically, the ISEs solicitation mechanism always aggregates Responses with orders when determining whether sufficient size exists to execute the entire Agency Order. BOX,

²⁵ See Notice, supra note 3, at note 8.

²⁶ The consistency with the Act of a price-time priority system that gives Public Customers no priority in trading rights is discussed, in the context of BOX, in Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (SR-BSE-2002-15) (Order Establishing Trading Rules for the Boston Options Exchange facility).

however, aggregates Responses with orders only if such Responses are at an improved price over the price proposed for the transaction. Responses are not aggregated with orders on the BOX Book when determining whether sufficient size exists to execute the entire Agency Order at the proposed solicitation price.²⁷

Regarding the differential treatment of Responses in these two scenarios, the Commission notes that the solicitation mechanisms on other exchanges, on which BOX's proposed Solicitation Auction generally is modeled, assure that when sufficient interest can be attracted through the exposure of an agency order to obtain a price better than the proposed execution price for the entire agency order, the agency order should receive that price improvement.²⁸ On the other hand, in the case where price improvement is not elicited for the entire agency order, such solicitation mechanisms provide for the execution to the solicited order against the agency order, even when non-public customer interest (including responses) in the aggregate would provide enough size to fill the entire agency order.²⁹ It is only the presence of a public customer order at the proposed price that prevents the execution of the solicited order against the agency order, so as not to bypass that public customer.

Responses exist only as a result of a solicitation auction and only for the possibility of eliciting a better price for an agency order in its entirety. Responses were not designed to elicit interest to fill the agency order at the same price as that proposed by the solicited order. In particular, a distinctive feature of solicitation mechanisms is that the solicited order is executed

²⁷ See supra note 10.

²⁸ See supra note 23.

²⁹ For a more complete discussion of the rationale for these aspects of the Solicited Order Mechanism, see generally Securities Exchange Act Release Nos. 49141 (January 28, 2004), 69 FR 5625 (February 5, 2004) (SR-ISE-2001-22) (Notice); and 49943 (June 30, 2004), 69 FR 41317 (July 8, 2004) (SR-ISE-2001-22) (Approval Order).

against the agency order even when non-public customer orders could fill the agency order at the proposed price, so long as those orders do not improve the price for the entire size of the agency order. On BOX, Public Customer orders generally are not granted any more deference than other orders on the BOX Book. Nonetheless, in its Solicitation Auction, consistent with the operation of solicitation mechanisms at other exchanges, BOX will not permit a Solicited Order to trade against the Agency Order when it would bypass a Public Customer Order at the same price, so long as that order was on the Book within the depth of interest that would have traded with the Agency Order had the Agency Order been submitted unmatched. If other interest on the Book can fill the balance of the Agency Order, BOX further will permit the Public Customer Order, together with such other interest, to fill the Agency Order. The Commission believes that it is reasonable and consistent with the Act for BOX to not aggregate Responses in this case because the sole purpose in eliciting Responses in the Solicitation Auction is to explore whether any possibility exists to obtain price improvement for the entire Agency Order.

Regarding BOX's introduction of the Surrender Quantity, the Commission believes that this function could help facilitate the execution of block-sized orders, while avoiding trade-throughs of better priced bids (offers) on the BOX Book and not bypassing Public Customer orders that would have traded with the Agency Order if the Agency Order had been submitted to the BOX Book.

The Exchange has adopted an interpretive provision to make clear that it would be a violation of an Options Participant's duty of best execution to its customer if it were to cancel a facilitation order to avoid execution of the order at the better price. Use of the Facilitation Auction does not modify an Options Participant's best execution duty to obtain the best price for its customer. Accordingly, while Facilitation Orders may be canceled during the facilitation

timeframe, if an Options Participant was to cancel a facilitation order when there was a superior price available on the Exchange and subsequently re-enter the facilitation order at the same facilitation price after the better price was no longer available without attempting to obtain that better price for its customer, there would be a presumption that the member did so to avoid execution of its customer order by other market participants.

The Commission believes that this interpretation is important to ensure that brokers proposing to facilitate orders as principal fulfill their best execution duties to their customers. In the Commission's view, withdrawing a facilitated order that may be price improved simply to avoid execution of the order at the superior price is a violation of a broker's duty of best execution.³⁰ The Commission expects the Exchange to establish procedures to surveil for violations of this best execution obligation.³¹

Finally, the Commission believes that it is reasonable and consistent with the Act for orders and Responses to be entered into the Exchange's Facilitation and Solicitation Auctions and receive executions at penny increments (the 'Penny Increment functionality'). The Commission notes that the Exchange is not restricting the ability of any Options Participant to enter orders and Responses in penny increments into the Exchange's Facilitation and Solicitation Auctions on its own behalf or on behalf of any other person, including customers. The Commission believes

³⁰ See, e.g., Securities Exchange Act Release No. 49175 (February 3, 2004), 69 FR 6124 (February 9, 2004) (Commission concept release on 'Competitive Developments in the Options Markets'), citing *In the Matter of the Application of the International Securities Exchange, LLC For Registration as a National Securities Exchange*, Release No. 42455 (Feb. 24, 2000).

³¹ The Commission realizes that ensuring that Options Participations do not re-enter facilitated orders on markets other than the Exchange may be difficult. Nevertheless, the Commission expects the Exchange to work with the other options markets through the Intermarket Surveillance Group to develop methods and procedures to monitor their Options Participants trading on other markets for possible best execution violations in this context.

that the Penny Increment functionality could provide greater flexibility in pricing for block-size orders and could provide enhanced opportunities for block-sized orders to benefit from price improvement, while ensuring broad access to persons that would like to participate in a one-cent increment. In addition, the Commission notes that it has previously approved rules relating to exchange crossing mechanisms that allow orders and executions in penny increments.³²

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³³ that the

³² See Securities Exchange Act Release Nos. 49068 (January 14, 2003), 68 FR 3062 (January 22, 2003) (Commission approval establishing trading rules for BOX, including rules for the Price Improvement Period); 49323 (February 26, 2004), 69 FR 10087 (March 3, 2004) (Commission approval establishing rules for ISE's Price Improvement Mechanism); and 53222 (February 3, 2006), 71 FR 7089 (February 10, 2006) (Commission approval establishing rules for CBOE's Automated Improvement Mechanism). These mechanisms allow for the execution of orders at penny increments even when the standard minimum trading increment is greater than one penny.

³³ 15 U.S.C. 78s(b)(2).

proposed rule change (SR-BX-2011-034) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁴

Elizabeth M. Murphy
Secretary

³⁴ 17 CFR 200.30-3(a)(12).