SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-60525; File No. SR-NASDAQ-2009-056)

August 18, 2009

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Granting Approval of a Proposed Rule Change as Modified by Amendment No. 1 Thereto to Adopt Rules Implementing the Options Order Protection and Locked/Crossed Market Plan

I. Introduction

On June 23, 2009, The NASDAQ Stock Market LLC ("Nasdasq" 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 and adopt rules to implement the Options Order Protection and Locked/Crossed Market Plan. The proposed rule change was published for comment in the Federal Register on July 8, 2009.[3] On August 14, 2009, the Exchange filed Amendment No. 1 to the proposed rule change.[4] The Commission received no comments on the proposal. This order approves the proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposal

The Exchange proposes to amend and adopt new Nasdaq rules to implement the Options Order Protection and Locked/Crossed Market Plan ("Plan").[5] Specifically, the Exchange

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 60186 (June 29, 2009), 74 FR 32657 ("Notice").

4 Amendment No. 1 made technical corrections to the rule text proposed by Nasdaq. Because the amendment did not affect the substance of the rule filing, the amendment did not require notice and comment.

5 The Plan is a national market system plan proposed by the seven existing options exchanges and approved by the Commission. See Securities Exchange Act Release No. 59647 (March 30, 2009), 74 FR 15010 (April 2, 2009) (File No. 4-546) ("Plan Notice") and 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (File No. 4-546) ("Plan

proposes to replace current Chapter XII of its rules with new rules implementing the Plan, amend other Exchange rules to reflect the Plan, and delete rules rendered unnecessary by the Plan.

The Old Plan

Each of the Participating Options Exchanges are signatories to the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage ("Old Plan").[6] In pertinent part, the Old Plan generally requires its participants to avoid trading at a price inferior to the national best bid or offer ("trade-through"), although it provides for a number of exceptions to trade-through liability.[7] The Participating Options Exchanges comply with this requirement of the Old Plan by utilizing a stand alone system ("Linkage Hub") to send and receive specific order types,[8] namely Principal Acting as Agent Orders ("P/A Orders"), Principal Orders, and Satisfaction Orders.[9] The Old Plan also provided that dissemination of "locked" or "crossed" markets should be

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Approval"). The seven options exchanges are: Chicago Board Options Exchange, Incorporated ("CBOE"); International Securities Exchange LLC ("ISE"); NASDAQ OMX BX, Inc. ("BOX"); NASDAQ OMX PHLX, Inc. ("Phlx"); NYSE Amex LLC ("NYSE Amex"); NYSE Arca, Inc. ("NYSE Arca"); and Nasdaq (each exchange individually a "Participant" and, together, the "Participating Options Exchanges").

[6] On July 28, 2000, the Commission approved the Old Plan as a national market system plan for the purpose of creating and operating an intermarket options market linkage proposed by the American Stock Exchange LLC (n/k/a NYSE Amex), CBOE, and ISE. See Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000). Subsequently, Philadelphia Stock Exchange, Inc. (n/k/a Phlx), Pacific Exchange, Inc. (n/k/a NYSE Arca), Boston Stock Exchange, Inc. (n/k/a BOX), and Nasdaq joined the Linkage Plan. See Securities Exchange Act Release Nos. 43573 (November 16, 2000), 65 FR 70851 (November 28, 2000); 43574 (November 16, 2000), 65 FR 70850 (November 28, 2000); 49198 (February 5, 2004), 69 FR 7029 (February 12, 2004); and 57545 (March 21, 2008), 73 FR 16394 (March 27, 2008).

[7] Section 8(c) of the Old Plan.

[8] The Linkage Hub is a centralized data communications network that electronically links the Participating Options Exchanges to one another. The Options Clearing Corporation ("OCC") operates the Linkage Hub.

[9] Section 2(16) of the Old Plan.

avoided, and remedial actions that should be taken to unlock or uncross such market.[10] Each of the Participating Options Exchanges, including the Exchange, has submitted an amendment to the Old Plan to withdraw from such Plan.[11] The withdrawals will be effective upon approval by the Commission of such amendments pursuant to Rule 608 of Regulation NMS under the Act ("Regulation NMS").[12]

The Plan

The Plan does not require a central linkage mechanism akin to the Old Plan's Linkage Hub. Instead, the Plan includes the framework for routing orders via private linkages that exist for NMS stocks under Regulation NMS.[13] The Plan requires the Participating Options Exchanges to adopt rules "reasonably designed to prevent Trade-Throughs."[14] Participating Options Exchanges are also required to conduct surveillance of their respective markets on a regular basis to ascertain the effectiveness of the policies and procedures to prevent Trade-

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10 Section 7(a)(i)(C) of the Old Plan.

11 See Securities Exchange Act Release No. 60360 (July 21, 2009) 74 FR 37265 (July 28, 2009) (File No. 4-429).

12 17 CFR 242.608.

13 See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (File No. S7-10-04); 17 CFR 242.600 et seq. For discussions of the similarities between the provisions of Regulation NMS and the provisions in the Plan, see the Plan Notice and Plan Approval, supra note 5.

14 Under the Plan, a "Trade-Through" is generally defined as a transaction in an option series, either as principal or agent, at a price that is lower than a Protected Bid or higher than a Protected Offer." See Section 2(21) of the Plan. A "Protected Bid" and "Protected Offer" generally means a bid or offer in an option series, respectively, that is displayed by a Participant, is disseminated pursuant to the Options Price Reporting Authority ("OPRA") Plan, and is the Best Bid or Best Offer. See Section 2(17) of the Plan. A "Best Bid" or "Best Offer" means the highest bid price and the lowest offer price. Section (2)(1) of the Plan. "Protected Bid" and "Protected Offer," together are referred to herein as "Protected Quotation." See Section 2(18) of the Plan.

Throughs and to take prompt action to remedy deficiencies in such policies and procedures.[15] As further described below, the Plan incorporates a number of exceptions to trade-through liability.[16] Some of these exceptions are carried over from the Old Plan, including exceptions for trading rotations, non-firm quotes, and complex trades.[17] Others are substantially similar to exceptions available for NMS stocks under Regulation NMS, such as exceptions for systems issues, crossed markets, quote flickering, customer stopped orders, benchmark trades and, notably, intermarket sweep orders ("ISOs").[18] In addition, the Plan contains a new exception for stopped orders and price improvement.[19]

The Plan also requires each Participant to establish, maintain, and enforce written rules that: require its members reasonably to avoid displaying locked and crossed markets; assure the reconciliation of locked and crossed markets; and prohibit its members from engaging in a pattern or practice of displaying locked and crossed markets; subject to exceptions as may be contained in the rules of the Participant, as approved by the Commission.[20]

The Exchange's Proposal

To implement the Plan, the Exchange proposes to replace its current rules relating to the Old Plan with new rules relating to the Plan, and makes amendments to other rules as necessary

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15 Section 5(a)(ii) of the Plan.

16 Section 5(b) of the Plan.

17 Subparagraphs (ii), (vii), and (viii), respectively, of Section 5(b) of the Plan.

18 Subparagraphs (i), (iii), (vi), (ix), (xi), and (iv)-(v), respectively, of Section 5(b) of the Plan.

19 Subparagraph (x) of Section 5(b) of the Plan.

20 Section 6 of the Plan. The Plan also contains provisions relating to the operation of the Plan including, for example, provisions relating to the entry of new parties to the Plan; withdrawal from the Plan; and amendments to the Plan.

to conform to the requirements of the Plan.[21] As such, the Exchange proposes to adopt all applicable definitions from the Plan into the Exchange's rules.[22]

In addition, the Exchange proposes to prohibit its members from effecting Trade-Throughs, unless an exception applies.[23] Consistent with the Plan, the Exchange also proposes exceptions to the prohibition on trade throughs relating to: system issues; trading rotations; crossed markets; intermarket sweep orders; quote flickering; non-firm quotes; complex trades; customer stopped orders; stopped orders and price improvement; and benchmark trades.[24]

The Exchange also proposes a rule to address locked and crossed markets, as required by the Plan.[25] Specifically, the Exchange proposes that, except for quotations that fall within a stated exception, members shall reasonably avoid displaying, and shall not engage in a pattern or practice of displaying, any quotations that lock or cross a Protected Quote.[26]

The Exchange proposes three exceptions to the prohibition against locked and crossed markets: when the Exchange is experiencing a failure, material delay, or malfunction of its systems or equipment; when the locking or crossing quotation was displayed at a time where there is a

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[21] A more detailed description of the Exchange's proposed rule change may be found in the Notice, supra, note 3.

[22] Proposed Nasdaq Chapter XII, Section 1.

[23] Proposed Nasdaq Chapter XII, Section 2(a).

[24] Proposed Nasdaq Chapter XII, Section 2(b)(1)-(11). In addition, the Exchange proposes to add ISOs as a new type of order under proposed Nasdaq Chapter VI, Section 1(e)(8).

[25] A "locked market" is defined as a quoted market in which a Protected Bid is equal to a Protected Offer. Proposed Nasdaq Chapter XII, Section 1(10). A "crossed market" is defined as a quoted market in which a Protected Bid is higher than a Protected Offer. Proposed Nasdaq Chapter XII, Section 1(5).

[26] Proposed Nasdaq Chapter XII, Section 3(a).

crossed market; and when an Exchange member simultaneously routes an ISO to execute against the full displayed size of any locked or crossed Protected Bid or Protected Offer.[27]

The Exchange also proposes rules to permit it to continue to accept P/A Orders and Principal Orders from Participating Options Exchanges that are not able to send ISOs in order to avoid Trade-Throughs.[28]

The Exchange proposes to amend certain other rules to reflect the Plan and delete terms related to the Old Plan. In particular, the Exchange proposes to amend Nasdaq Chapter IV, Section 5(b) and (c) and Nasdaq Chapter VII, Section 5(a)(viii) to modify language that is no longer applicable under the Plan and eliminate the "Removal of Unreliable Quotes" provision of Nasdaq Chapter 12, Section 3(e).[29]

NASDAQ proposes to implement this proposed rule change upon withdrawal from the current Linkage Plan and effectiveness of the new Plan.

II. Discussion and Commission's Findings

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[30] In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act[31] which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to

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27 Proposed Nasdaq Chapter XII, Section 3(b).

28 Proposed Nasdaq Chapter XII, Section 4.

29 In addition, the Exchange proposes to rely upon the order routing arrangements already in place on its market.

30 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).

31 15 U.S.C. 78f(b)(5).

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. The Commission also finds that the proposal is consistent with Rule 608(c) of Regulation NMS under the Act, which requires that each exchange comply with the terms of any effective national market system plan of which it is a participant.[32] Finally, the Commission finds that the proposed rule change is consistent with the requirements of the Plan.[33]

Proposed Nasdaq Chapter XII, Section 1 would define applicable terms in a manner that are substantively identical to the defined terms of the Plan.[34] As such, the Commission finds that proposed Nasdaq Chapter XII, Section 1 is consistent with the Act and the Plan.

Proposed Nasdaq Chapter XII, Section 2(a) would prohibit members from effecting Trade-Throughs unless an exception applies. Proposed Nasdaq Chapter XII, Section 2(b) would provide for 11 exceptions to the general Trade-Through prohibition, relating to systems issues, trading rotations, crossed markets, ISOs, quote flickering, non-firm quotes, complex trades, customer stopped orders, stopped orders and price improvement, and benchmark trades.[35] Aside from the proposed exception relating to systems issues, each proposed exception would be substantively identical to the parallel exception under Section 5(b) of the Plan.

The systems issues exception under proposed Nasdaq Chapter XII, Section 2(b)(1) would implement the parallel exception available under Section 5(b)(i) of the Plan and would permit the

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32 17 CFR 242.608(c). Section 1 of the Plan provides in pertinent part that, "The Participants will submit to the [Commission] for approval their respective rules that will implement the framework of the Plan."

33 <u>See</u> <u>supra</u> note 5.

34 The Commission notes that the Exchange's proposed definition of "Complex Trade" under proposed Nasdaq Chapter XII, Section 1(4) is identical to the definition of "Complex Trade" under old Nasdaq Chapter XII, Section 1(c), which is being deleted.

35 Proposed Nasdaq Chapter XII, Section 2(b)(1)-(11).

Exchange to bypass the Protected Quotation of another Participant if such other Participant repeatedly fails to respond within one second to incoming orders attempting to access its Protected Quotations. The Exchange's rule would require the Exchange to notify such non-responding Participant immediately after (or at the same time as) electing self-help, and assess whether the cause of the problem lies with the Exchange's own systems and, if so, take immediate steps to resolve the problem. Finally, the Exchange would be required to promptly document its reasons supporting any such determination to bypass a Protected Quotation. The Commission believes that this exception should provide the Exchange with the necessary flexibility for dealing with problems that occur on an away market during the trading day. At the same time, the exception's requirements to immediately notify such away market of its determination and also assess its own system should help prevent the use of this exception when there in fact is a problem with the Exchange's own systems, rather than those of an away market.

The Commission notes that included among the exceptions in proposed Nasdaq Chapter XII, Section 2(b) would be exceptions for certain transactions involving ISOs.[36] An order identified as an ISO would be immediately executable by the Exchange (or any other Plan Participant that received such an order) based on the premise that the market participant sending the ISO has already attempted to access all better-priced Protected Quotations up to their displayed size. The Commission believes that this exception should help ensure more efficient and faster executions in the options markets.

The Commission notes that, in addition to these rules regarding Trade-Throughs, the Plan requires that each Participant establish, maintain and enforce written policies and procedures that are reasonably designed to prevent Trade-Throughs in that Participant's market that do not fall

[36] Proposed Nasdaq Chapter XII, Sections 2(b)(4) and (5).

within an applicable exception and, if relying on such exception, that are reasonably designed to assure compliance with the terms of the exception. In addition, the Commission notes that the Plan requires each Participant to conduct surveillance of its market on a regular basis to ascertain the effectiveness of such policies and procedures and to take prompt action to remedy any deficiencies in such policies and procedures.

Accordingly, the Commission finds that proposed Nasdaq Chapter XII, Section 2 is consistent with Section 5 of the Plan and Section 6(b)(5) of the Act[37] which requires, among other things, that the rules of a national securities exchange be designed 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.

Proposed Nasdaq Chapter XII, Section 3(a) would require Exchange members to reasonably avoid displaying, and not engage in a pattern or practice of displaying, any quotation that lock or cross a Protected Quotation, subject to certain exceptions delineated in proposed Nasdaq Chapter XII, Section 3(b). The Commission recognizes that locked and crossed markets may occur accidentally and cannot always be avoided. However, the Commission believes that giving priority to the first-displayed Protected Bid or Protected Offer, particularly when it includes a public customer's order, will encourage price discovery and contribute to fair and orderly markets. Therefore, the Commission believes that the proposed rule, which corresponds to the Plan's language, to require members to <u>reasonably</u> avoid displaying, and not engaging in a <u>pattern or practice</u> of, locks and crosses is appropriate.

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[37] 15 U.S.C. 78f(b)(5).

Proposed Nasdaq Chapter XII, Section 3(b) would permit three exceptions to the Exchange's general rule relating to locked and crossed markets.[38] These exceptions would be similar to analogous certain trade-through exceptions under proposed Nasdaq Chapter XII, Section 2(b), and relate to when the Exchange is experiencing systems issues, when there is exists a crossed market, and when a member simultaneously routes ISOs against the full displayed size of any locked or crossed Protected Bid or Protected Offer.

The Commission believes that the Exchange's proposed rules relating to locked and crossed markets are consistent with the Plan and the Act and should help ensure that the display of locked or crossed markets will be limited and that any such display will be promptly reconciled. The Commission also believes that each of the proposed exceptions to locked and crossed markets relate to circumstances when it is appropriate to permit a limited, narrow exception to the general locked and crossed market rule.

Therefore, the Commission finds that Exchange's rule regarding locked and crossed markets appropriately implements Section 6 of the Plan, and is consistent with Section 6(b)(5) of the Act[39] which requires, among other things, that the rules of a national securities exchange be designed 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.

The Commission also finds that proposed Nasdaq Chapter XII, Section 4, which facilitates the participation of certain Participating Options Exchanges who may require the use of P/A Orders and Principal Orders after implementation of the Plan, is consistent with the Act.

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38 Section 6 of the Plan permits exceptions to the Plan's locked and crossed market rules as may be contained in the rules of a Participant approved by the Commission.

39 15 U.S.C. 78f(b)(5).

Although the Commission has already approved the Plan,[40] the Commission also recognizes that there may be one or more Participating Options Exchanges that may require a temporary transition period during which they may want to continue to utilize these order types that exist currently under the Old Plan.[41] The Exchange and each of the other Participating Options Exchanges have proposed substantially identical temporary provisions to accommodate this possibility.[42] Thus, the Commission finds that the proposed rule relating to the Exchange's receipt and handling of P/A Orders and Principal Orders, and imposing certain obligations on the Exchange with respect to such orders that are similar to those that exist under the Old Plan, is appropriate and consistent with Section 6(b)(5) of the Act[43] which requires, among other things, that the rules of a national securities exchange be designed 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.

Finally, the Commission finds that Nasdaq's proposed amendments to certain other Nasdaq rules to modify and/or delete language that is no longer necessary under the Plan are appropriate and consistent with the Act and the Plan.

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40 See Plan Approval, supra, note 5.

41 The Commission notes that any Participating Options Exchange that wishes to utilize such order types in a manner that would result in a Trade-Through would need to separately request an exemption from the Plan for such use.

42 The Commission notes that the rules contained in Proposed Nasdaq Chapter XII, Section 4 are not required by the Plan, but rather are rules proposed by the Exchange in order to facilitate the participation in the Plan of certain exchanges during an initial transition period.

43 15 U.S.C. 78f(b)(5).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[44] that the proposed rule change (SR-NASDAQ-2009-056), as modified by Amendment No. 1, be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[45]

Florence E. Harmon
Deputy Secretary

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44 15 U.S.C. 78s(b)(2).

45 17 CFR 200.30-3(a)(12).