

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61735; File No. SR-NASDAQ-2010-007)

March 18, 2010

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Approving Proposed Rule Change, as Modified by Amendment No. 1, Relating to the Elimination of a Market Maker Requirement for Each Option Series

I. Introduction

On January 14, 2010, The NASDAQ Stock Market LLC (“Nasdaq” 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 eliminate the requirement that at least one Options Market Maker³ must be registered for trading a particular series before it may be opened for trading on the Nasdaq Options Market (“NOM”). On January 26, 2009, the Exchange filed Amendment No. 1 to the proposal. The proposed rule change, as modified by Amendment No. 1, was published for comment in the Federal Register on February 4, 2009.⁴ The Commission received one comment letter on the proposal.⁵ This order approves the proposed rule change, as modified by Amendment No. 1.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ An “Options Market Maker” is a Participant registered with NASDAQ as a Market Maker. See NOM Rules, Chapter I, Section 1(a)(26) and Chapter VII, Section 2. An “Options Participant” or “Participant” is a firm or organization that is registered with the Exchange pursuant to Chapter II of the NOM Rules for purposes of participating in options trading on NOM as a “NASDAQ Options Order Entry Firm” or “NASDAQ Options Market Maker.” See NOM Rules, Chapter I, Section 1(a)(40).

⁴ See Securities Exchange Act Release No. 61443 (January 29, 2010), 74 FR 46267 (“Notice”).

⁵ See letter from Janet M. Kissane, Senior Vice President – Legal and Corporate Secretary, NYSE Euronext, to Elizabeth M. Murphy, Secretary, Commission, dated February 26, 2010 (“NYSE Euronext Comment Letter”).

II. Description of the Proposal

Currently, Chapter IV, Section 5 of the NOM rulebook provides, in relevant part, that after a particular class of options has been approved for listing on NOM by NASDAQ Regulation, NASDAQ will open trading in series of options in that class only if there is at least one Market Maker registered for trading that particular series. The Exchange is now proposing to eliminate this requirement to have a Market Maker in every series. The Exchange argues that removing this requirement will expand the number of series available to investors for trading and for hedging risks associated with securities underlying those options. Further, the Exchange asserts that market makers currently may choose to register as Market Makers in a particular series solely to permit an option to trade on NOM. The Exchange believes that the proposed rule change will permit Market Makers to focus their expertise on the products that are more consistent with their business objectives or more likely to attract customer order flow.

The Exchange also notes that the Options Order Protection and Locked/Crossed Market Plan requires plan participants (such as Nasdaq) to establish, maintain and enforce written policies and procedures that are reasonably designed to prevent trade-throughs in that participant's market in Eligible Options Classes.⁶ Further, the Exchange notes that NOM has put in place rules to implement this provision of the Plan, and that its systems are designed to systematically avoid trading through protected quotations on other options exchanges.⁷ Thus, the

⁶ See Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (File No. 4-546) (approval order for the Protection and Locked/Crossed Plan).

⁷ See NOM Rules, Chapter XII, Section 2; and Securities Exchange Act Release No. 60525 (August 18, 2009), 74 FR 43188 (August 26, 2009) (approval order for NOM's proposed rule change to implement the Protection and Locked/Crossed Plan).

Exchange believes that the lack of a two-sided or tight market on NOM would not cause customer orders to be executed at prices inferior to the best prices available across all exchanges.

In addition, the Exchange is proposing to delete paragraph (b) of Section 5, Chapter IV, which states that a class of options will be put into a non-regulatory halt if at least one series for that class is not open for trading. The Exchange explains that this provision was put in place so that the Exchange could approve underlying securities for the listing of options but delay the listing if the Market Makers on the Exchange were not yet ready to register in any series of options for that class. With the elimination of the other paragraph in Section 5 requiring a Market Maker in each option series, the Exchange believes this provision is no longer necessary.

III. Discussion and Commission 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 and, in particular, with Section 6(b)(5) of the Act,⁸ which requires, among other things, that the rules of a national securities exchange 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.⁹

⁸ 15 U.S.C. 78f(b)(5).

⁹ 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).

The Commission has stated previously that it does not believe that the Act requires an exchange to have market makers.¹⁰ In making this finding in connection with its approval of NOM, the Commission stated that the Act does not mandate a particular market model for national securities exchanges, and many different types of market models can satisfy the requirements of the Act. The Commission further noted that although Market Makers could be an important source of liquidity on NOM, they likely would not be the only source.¹¹ Similarly, in adopting Regulation ATS, the Commission found that assuring liquidity through the posting of continuous two-sided quotations was not a necessary component of an exchange.¹²

In its comment letter, NYSE Euronext notes that NOM Market Makers are considered specialists under the Act and are required to engage in a course of dealings for their own account to assist in the maintenance of a fair and orderly market. As such, NYSE Euronext argues that the Exchange's proposal would result in no one being responsible for the maintenance of a fair and orderly market on NOM where there is no Market Maker registered in a series.¹³ NYSE

¹⁰ See Securities Exchange Act Release Nos. 57478 (March 12, 2008), 73 FR 14521, 14527 (March 18, 2008) (File No. SR-NASDAQ-2007-004) ("NOM Approval Order") and Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Release").

¹¹ See NOM Approval Order, *supra* note 10, at 14527.

¹² Regulation ATS Release, *supra* note 10, at 70898-70900. Specifically, the Commission stated, "[A]lthough traditional exchanges still provide liquidity through two-sided quotations and, hence, raise an expectation of execution at the quoted price, this is no longer an essential characteristic of a securities market . . . Market makers and specialists may be important liquidity providers on a particular exchange, but liquidity now comes from many sources across multiple markets. For example, the public exposure of investor limit orders means that it is now easier to access liquidity in trading venues that do not have market makers or specialists." *Id.* at 70899.

¹³ See NYSE Euronext Comment Letter, *supra* note 5, at 1.

Euronext also suggests that Nasdaq seek an exemption under Section 11(c) of the Act “to be relieved of the obligation to appoint a specialist.”¹⁴

As stated above, the Commission believes that the Act does not require an exchange to have specialists or market makers and that Market Makers are not the only source of liquidity on an exchange. Moreover, Section 11 of the Act does not require exchanges to have specialists or market makers. Section 11(b) of the Act permits, but does not require, a national securities exchange to allow a member to be registered as a specialist.¹⁵ Accordingly, the Commission disagrees with NYSE Euronext’s assertion that Nasdaq is required to seek an exemption to allow it to eliminate its Market Maker listing requirement.

NYSE Euronext also argues that when Nasdaq originally adopted its rules governing NOM, the Securities Industry and Financial Markets Association (“SIFMA”) submitted a comment letter that raised the issue of having a market maker appointed in each series (“SIFMA Comment Letter”).¹⁶ In particular, NYSE Euronext notes that the SIFMA Comment Letter stated that Nasdaq should clarify the treatment of option series without a market maker, including what actions would be taken should a Market Maker withdraw from making a market in a particular series and whether NOM would continue to match orders in such series. NYSE Euronext maintains that Nasdaq should address why SIFMA’s concerns are no longer valid.

The Commission notes that these comments in the SIFMA Comment Letter did not raise questions as to whether having a series without a Market Maker would be consistent with the

¹⁴ See NYSE Euronext Comment Letter, supra note 5, at 1.

¹⁵ 15 U.S.C. 78k(b).

¹⁶ See NYSE Euronext Comment Letter, supra note 5, at 1-2.

Act, but rather sought clarification as to what would occur should a Market Maker stop quoting or withdraw from making a market in a particular option series.¹⁷ As NYSE Euronext acknowledged in its comment letter, Nasdaq addressed the SIFMA Comment Letter by amending its rules to clarify the treatment of option series in such cases.¹⁸

NYSE Euronext also contends that Nasdaq should be required to assist brokers in fulfilling their duty of best execution because many permit holders on NYSE Arca Inc. (“Arca”) and NYSE Amex LLC (“Amex”) routinely route orders to multiple exchanges as part of their due diligence.¹⁹ Specifically, NYSE Euronext states that Nasdaq should be required to cancel back to brokers any resting orders in a series where a registered market maker is not quoting or to send an alert that a registered market maker quotation is no longer present.²⁰

The duty of best execution requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer's transaction.²¹ The Commission has not viewed the duty of best execution as requiring automated routing on an order-by-order basis to the market with the best quoted price at that time. Rather, the duty of best execution requires broker-dealers to periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customer orders.²²

¹⁷ See NOM Approval Order, supra note 10, at 14526.

¹⁸ See NYSE Euronext Comment Letter, supra note 5, at 1-2.

¹⁹ See NYSE Euronext Comment Letter, supra note 5, at 2.

²⁰ See id.

²¹ See, e.g., Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996), at 48322 (“Order Handling Rules Release”).

²² Id. at 48322-48333 (“[I]n 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

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 terms.²³ 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.²⁴ The Commission believes that the potential lack of a Market Maker quoting in particular series will be a factor to be considered in a broker-dealer's best execution routing determination, similar to other factors a broker-dealer must consider in connection with its best execution obligation.

The NYSE Euronext Comment Letter also questions how Nasdaq's proposal fosters transparency, price competition, and the development of the national market system.²⁵ The Commission does not believe that the proposal will have a negative affect on price transparency, as the prices and sizes of orders on NOM will continue to be disseminated on the consolidated tape even though Market Makers may not be posting two-sided quotations. Further, the Commission believes that the proposal could foster intermarket price competition by providing an additional market and source of liquidity for options series that would otherwise have been prohibited from trading on NOM due to the lack of a Market Maker registered in that series. Finally, the Commission does not believe that the proposal will have a negative effect on the

security.”). See also Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, at 271, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998); Payment for Order Flow, Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006 (November 2, 1994), at 55009.

²³ Order Handling Rules Release, supra note 21, at 48323.

²⁴ Id.

²⁵ See NYSE Euronext Comment Letter, supra note 5, at 2.

development of a national market system. As noted above, notwithstanding the elimination of the requirement to have a registered Market Maker trading in a particular series, NOM is designed to ensure, and the Options Order Protection and Locked/Crossed Market Plan requires that procedures are in place to ensure, that orders executed on NOM will not trade-through better prices on other options exchanges.

Finally, the NYSE Euronext Comment Letter expresses doubt about the necessity of the proposed rule change and suggests that if there is no Market Maker to trade a series, NOM should simply not list such series.²⁶ The Commission notes that a proposed rule change is not required to be “necessary” in order to be found consistent with the Act. Further, as Nasdaq noted, one of the primary purposes of the proposal is to expand the number of series available to investors for trading and hedging purposes on NOM, and NYSE Euronext’s recommendation would not advance this objective.

For the reasons noted above, the Commission believes that the proposed rule change is consistent with the Act.

²⁶ See NYSE Euronext Comment Letter, supra note 5, at 2.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁷ that the proposed rule change (SR-NASDAQ-2010-007), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁸

Florence E. Harmon
Deputy Secretary

²⁷ 15 U.S.C. 78s(b)(2).

²⁸ 17 CFR 200.30-3(a)(12).