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SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69719; File No. SR-NASDAQ-2013-031)

June 7, 2013

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Granting Approval to Proposed Rule Change to Amend the Attestation Requirement of Rule 4780 to Allow a Retail Member Organization to Attest that "Substantially All" Orders Submitted to the Retail Price Improvement Program Will Qualify as "Retail Orders"

I. Introduction

On February 19, 2013, 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 allow Retail Member Organizations ("RMOs") to attest that "substantially all," rather than all, orders submitted to the Exchange's Retail Price Improvement Program ("Program") qualify as "Retail Orders." The proposed rule change was published for comment in the Federal Register on March 11, 2013.[3] The Commission received one comment on the proposal.[4] NASDAQ submitted a response to the comment letter on April 24, 2013.[5] On April 25, 2013, the Commission extended the time for Commission action on the proposed rule change until June 9, 2013.[6] This order approves the proposed rule change.

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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. 69039 (March 5, 2013), 78 FR 15392.

4 See Letter to the Commission from Theodore R. Lazo, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association (SIFMA), dated March 11, 2013.

5 See Letter to the Commission from Jonathan F. Cayne, Associate General Counsel, NASDAQ OMX, dated April 24, 2013 ("Exchange's Response Letter").

6 See Securities Exchange Act Release No. 69450, 78 FR 25501 (May 1, 2013).

II. Description of the Proposal

The Exchange began operating the Program after it was approved by the Commission on a pilot basis in February, 2013.[7] Under the current rules, a member organization that wishes to participate in the Program as an RMO must submit: (A) an application form; (B) supporting documentation; and (C) an attestation that "any order" submitted as a Retail Order[8] will qualify as such under NASDAQ Rule 4780.

The proposal seeks to lessen the attestation requirements of RMOs that submit "Retail Orders" eligible to receive potential price improvement through participation in the Program. Specifically, the Exchange proposes to amend NASDAQ Rule 4780 to provide that an RMO may attest that "substantially all" – rather than all – of the orders it submits to the Program are Retail Orders as defined in Rule 4780(a)(2). NASDAQ states that the current "any order" attestation requirement is effectively preventing certain significant retail brokers from participating in the Program due to operational constraints.

The Exchange makes clear in its proposal that the "substantially all" standard is meant to allow only de minimis amounts of orders to participate in the Program that do not meet the definition of a Retail Order in NASDAQ Rule 4780(a)(2) and that cannot be segregated from bona fide Retail Orders due to systems limitations. Under the proposal, the Exchange would require that RMOs retain in their books and records adequate substantiation that substantially all

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[7] See Securities Exchange Act Release No. 68937 (February 15, 2013), 78 FR 12397 (February 22, 2012) ("RPI Approval Order").

[8] A Retail Order is defined in NASDAQ Rule 4780(a)(2) as "an agency or riskless principal order that originates from a natural person and is submitted to NASDAQ by a Retail Member Organization, provided that no change is made to the terms of the order with respect to price (except in the case that a market order is changed to a marketable limit order) or side of market and the order does not originate from a trading algorithm or any other computerized methodology."

orders sent to the Exchange as Retail Orders met the strict definition and that those orders not meeting the strict definition are agency orders that cannot be segregated from Retail Orders due to system limitations, and are de minimis in terms of the overall number of Retail Orders sent to the Exchange.[9]

III. Comment Letter and the Exchange's Response

The Commission received one comment on the proposal. The comment letter expressed concern over the proposed "substantially all" attestation requirement primarily for four reasons.

First, the comment letter questioned whether the proposal would undermine the rationale on which the Commission approved the Retail Price Improvement Program. According to the commenter, when the Commission granted approval to the Program, along with exemptive relief in connection with the operation of the Program, it did so with the understanding that the Program would service "only" retail order flow. To the extent the proposal would potentially allow non-Retail Orders to receive price improvement in the Program, the commenter suggested that the Commission should reexamine its rationale for granting the exemptive relief relating to the Program.

In response, NASDAQ noted that the proposed amendment is designed to permit isolated and de minimis quantities of agency or riskless principal orders that do not qualify as Retail Orders to participate in the Program, because such orders cannot be segregated from Retail Orders due to systems limitations. The Exchange also noted that several significant retail brokers choose not to participate in the Program currently because of the categorical "any order" standard, and that the proposed "substantially all" standard would allow the significant amount

[9] NASDAQ notes that the Financial Industry Regulatory Authority, Inc. ("FINRA"), on behalf of the Exchange, will review a member organization's compliance with these requirements.

of retail order flow represented by these brokers the opportunity to receive the benefits of the Program. Additionally, the Exchange noted that the Program is designed to replicate the existing practices of broker-dealers that internalize much of the market's retail order flow off-exchange, and that the Program, as modified by the "substantially all" proposal, would offer a competitive and more transparent alternative to internalization.

Second, the commenter expressed its belief that the Exchange did not sufficiently explain why retail brokers are not able to separate all Retail and non-Retail Orders and thereby satisfy the current attestation requirement. The commenter expressed its belief that the Commission should require additional explanation as to how retail brokers could satisfy the proposed "substantially all" standard if they could not satisfy the current standard, including an analysis of the costs and benefits to retail brokers of implementing technology changes to identify orders as Retail or non-Retail. Furthermore, the commenter suggested that the Exchange's proposal is at odds with the situation found in options markets where exchanges and brokers distinguish between public and professional customers – a distinction the commenter analogized to the Retail versus non-Retail distinction.

The Exchange responded that several retail brokers have explained that their order flow is routed in aggregate for retail execution purposes and that a de minimis amount of such flow may have been generated electronically, thus not meeting the strict Retail Order definition. According to NASDAQ, these retail brokers have chosen not to direct any of their significant shares of retail order flow to the Program because the cost of complying with the current "any order" standard, such as implementing any necessary systems changes, is too high. The Exchange represented that the retail brokers have indicated their willingness to comply with the proposed "substantially all" standard, as well as their ability to implement the proposed standard

on their systems with confidence. The Exchange further responded that the distinction between public and professional customers in the options market is not like distinction between Retail and non-Retail Orders; the former distinction turns on volume and is thus an easier bright-line threshold to implement, while the distinction between Retail and non-Retail Orders turns on whether the order originated from a natural person, which imposes a higher threshold for order flow segmentation purposes.

Third, the commenter contended that the proposed "substantially all" standard is overly vague. According to the commenter, the Exchange's proposed guidance on what constitutes "substantially all" is so vague that it could allow a material amount of non-retail order flow to qualify for the Program. The commenter suggested that, should the Commission approve the proposal, it should first establish a bright-line rule to define what constitutes "substantially all" retail order flow.[10]

NASDAQ responded that the proposal represents only a modest modification of the attestation requirement. In this respect, the Exchange noted that the proposal would permit only isolated and de minimis quantities of agency orders to participate in the Program that do not satisfy the strict definition of a Retail Order but that cannot be segregated from Retail Orders due to systems limitations. Furthermore, the Exchange noted that an RMO's compliance with this requirement would be monitored and subject to books and record-keeping requirements.

Fourth, the commenter stated that the proposal may cause an exponential increase in monitoring and recordkeeping burdens associated with the Program. The commenter expressed its belief that it could be especially difficult for the Exchange not just to identify non-retail order flow, but also to monitor whether such flow exceeded a de minimis amount. The commenter

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[10] The commenter cited one example where a "de minimis" transaction is defined in 17 C.F.R. 242.101(b)(7), in connection with a distribution of securities, as "less than 2%."

also questioned whether the potential difficulty of the Exchange monitoring the Program might increase the likelihood that members may be subject to unfair discrimination in the Program's approval and disqualification process.

In response, the Exchange noted that it will issue Equity Trader Alerts to provide clear guidance on how the "substantially all" standard will be implemented and monitored. The Exchange also noted that the Program is designed to attract as much retail order flow as possible, and that, should RMOs begin submitting substantial amounts of non-retail order flow, liquidity providers would become less willing to participate in the Program. Finally, the Exchange disagreed with the commenter's statement that a standard that provides a de minimis number of exceptions would be any harder to enforce that a standard that permitted no exceptions.

IV. Discussion and Commission Findings

After careful review of the proposal, the comment letter received, and the Exchange's response, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange. [11] In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,[12] 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 foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, 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

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[11] In approving the proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

[12] 15 U.S.C. 78f(b)(5).

public interest; and not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

The Commission finds that the proposed "substantially all" standard is a limited and sufficiently-defined modification to the Program's current RMO attestation requirements that does not constitute a significant departure from the Program as initially approved by the Commission.[13] The proposal makes clear that to comply with the standard, RMOs may submit only isolated and de minimis amounts of agency orders that cannot be segregated from Retail Orders due to systems limitations.[14] Furthermore, as the Exchange notes, RMOs will need to adequately document their compliance with the "substantially all" standard in their books and records. Specifically, an RMO would need to retain adequate documentation that substantially all orders sent to the Exchange as Retail Orders met that definition, and that those orders not meeting that definition are agency orders that cannot be segregated from Retail Orders due to system limitations, and are de minimis in terms of the overall number of Retail Orders sent to the Exchange. The Commission also notes that FINRA will monitor an RMO's compliance with this requirement.

Additionally, the Commission finds that the Exchange has provided adequate justification for the proposal. The Exchange represented that, as explained to it by several significant retail

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[13] The Commission notes that it approved the Program on a pilot basis subject to ongoing Commission review. The Commission notes further that it recently approved nearly identical proposals submitted by NYSE, NYSE MKT, and BATS-Y concerning those exchanges' respective retail programs. See Securities Exchange Act Release Nos. 69513 (May 3, 2013), 78 FR 27261 (May 9, 2013) (NYSE and NYSE MKT), and 69643 (May 28, 2013), 78 FR 33136 (June 3, 2013) (BATS-Y).

[14] While the Commission recognizes the potential benefit of the commenter's suggestion concerning a bright-line definition of de minimis, see supra note 10, the Commission believes that, in light of the facts surrounding the instant proposal, the proposal, and the guidance that the Exchange will provide to its members on this point, is sufficiently clear. The Commission also notes that the example the commenter cites is found in Regulation M, which governs different circumstances than those at issue here.

brokers, the current "any order" standard is effectively prohibitive, given the brokers' order flow aggregation and management systems. The Exchange further represented that these retail brokers indicated their systems would allow them to comply with the "substantially all" standard, as proposed. By allowing these retail brokers to participate in the Program, the proposal could bring the potential benefits of the Program, including price improvement and increased transparency,[15] to the retail order flow that these brokers represent.[16]

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15 For a more detailed discussion of the Program's potential benefits, see RPI Approval Order, supra note 7.

16 The commenter also expressed concern that this proposal may increase the Exchange's burden monitoring compliance with the Program. The Commission finds that any potential concerns raised by this assertion, which is disputed by the Exchange, are outweighed by the potential benefits of the proposal; namely, that the proposal may allow more retail orders the opportunity to participate in the Program and to receive the attendant benefits of the Program. With respect to the commenter's concern that members may be subject to unfair discrimination in the approval and disqualification process for participation in the Program, the Commission notes that it previously found that the Program's provisions concerning the certification, approval, and potential disqualification of RMOs are not inconsistent with the Act. See RPI Approval Order, supra note 7.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[17] that the proposed rule change (SR-NASDAQ-2013-031) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[18]

Kevin M. O'Neill
Deputy Secretary

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[17] 15 U.S.C. 78s(b)(2).

[18] 17 CFR 200.30-3(a)(12).