

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>48</sup>

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Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-71173; File No. SR-NASDAQ-2013-156]

### Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Adopt a New Options Execution Algorithm With Priority Overlays

December 23, 2013.

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> notice is hereby given that on December 16, 2013, The NASDAQ Stock Market LLC ("Nasdaq" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to amend Chapter VI, Section 10, of the Rules of the NASDAQ Options Market ("NOM"). Specifically, NASDAQ proposes to add an additional execution algorithm and priority overlays to govern the priority of orders, as explained more fully below.

The text of the proposed rule change is below; proposed new language is in *italics*.

\* \* \* \* \*

#### Chapter VI Trading Systems

\* \* \* \* \*

#### Sec. 10 Book Processing

System orders shall be executed through the Nasdaq Book Process set forth below:

(1) Execution Algorithm—*The Exchange will determine to apply, for each option, one of the following execution algorithms described in*

*paragraphs (A) or (B). The Exchange will issue an Options Alert specifying which execution algorithm will govern which options any time it is modified.*

(A) Price/Time—The System shall execute trading interest within the System in price/time priority, meaning it will execute all trading interest at the best price level within the System before executing trading interest at the next best price. Within each price level, *if there are two or more quotes or orders at the best price, trading interest will be executed in time priority.*

(B) Size Pro-Rata—*The System shall execute trading interest within the System in price priority, meaning it will execute all trading interest at the best price level within the System before executing trading interest at the next best price. Within each price level, if there are two or more quotes or orders at the best price, trading interest will be executed based on the size of each Participant's quote or order as a percentage of the total size of all orders and quotes resting at that price. If the result is not a whole number, it will be rounded down to the nearest whole number. If there are residual contracts remaining after rounding, such contracts will be distributed one contract at a time to the remaining Participants in time priority.*

(C) Priority Overlays Applicable to Size Pro-Rata Execution Algorithm: *The Exchange will apply the following designated Participant priority overlays, which are always in effect when the Size Pro-Rata execution algorithm is in effect.*

(i) Public Customer Priority: *the highest bid and lowest offer shall have priority except that Public Customer orders shall have priority over non-Public Customer orders at the same price. If there are two or more Public Customer orders for the same options series at the same price, priority shall be afforded to such Public Customer orders in the sequence in which they are received by the System. For purposes of this Rule, a Public Customer order does not include a Professional Order.*

(ii) Market Maker Priority: *After all Public Customer orders have been fully executed, Options Market Makers shall have priority over all other Participant orders at the same price. If there are two or more Options Market Maker quotes and orders for the same options series at the same price, those shall be executed based on the Size Pro-Rata execution algorithm. If there are contracts remaining after all Market Maker interest has been fully executed, such contracts shall be executed based on the Size Pro-Rata execution algorithm.*

(2)–(7) No change.

\* \* \* \* \*

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

##### (A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

NOM operates as an all-electronic system ("System" or "Trading System") with no physical trading floor and provides for the electronic display and execution of orders in price/time priority without regard to the status of the entities that are entering orders. NOM now seeks to introduce a different priority rule in certain options in order to create additional incentives for firms to provide liquidity on NOM.

Currently, Chapter VI, Section 10, Book Processing, provides that the System will have a single execution algorithm based on price/time priority. The System and rules provide for the ranking, display, and execution of all orders in price/time priority without regard to the status of the entity entering an order. For each order, among equally-priced or better-priced trading interest, the System currently executes against available contra-side displayed contract amounts in full, in price/time priority.

At this time, the Exchange proposes to amend Chapter VI, Section 10, to provide for a Size Pro-Rata execution algorithm. In order to make clear that only one of the two execution algorithms is applicable to a particular option, NASDAQ proposes to add introductory language to Section 10(1) to state that the Exchange will determine to apply, for each option, one of the execution algorithms described in subparagraphs (A)<sup>3</sup> or (B). The

<sup>3</sup> NASDAQ is also proposing to amend subparagraph (A) to provide that, respecting the price/time execution algorithm, within each price level, if there are two or more quotes or orders at the best price, trading interest will be executed in time priority. This is intended to be clearer and match the new language in subparagraph (B).

<sup>48</sup> See 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

Exchange will issue an Options Alert specifying which execution algorithm will govern which options any time a change is made.

Further, NASDAQ proposes to adopt new subparagraph (B) to provide that when the Size Pro-Rata execution algorithm is in effect the System shall execute trading interest in price priority, meaning it will execute all trading interest at the best price level within the System before executing trading interest at the next best price. Within each price level, if there are two or more quotes or orders at the best price, trading interest will be executed based on the size of each Participant's quote or order as a percentage of the total size of all orders and quotes resting at that price. If this is not a whole number, it will be rounded down to the nearest whole number. If there are residual contracts remaining after rounding, such contracts will be distributed one contract at a time to the remaining Participants in time priority.<sup>4</sup> The Size Pro-Rata execution algorithm will, initially, always operate with the priority overlays, as described further below.

*Example 1—rounding approach* Order 1: Buy 10 contracts for 1.84, Non-Market Maker broker-dealer  
Order 2: Buy 10 contracts for 1.84, Public Customer  
Quote: 1.84 (70) x 1.86 (10) MM1  
Order 3: Buy 10 contracts for 1.84, Market Maker  
Market: 1.84 (100 contracts total) x 1.86 (10 contracts)  
Sell order received: Sell 25 contracts at 1.84  
Execution:  
Order 1 represents 10 of 100 (10%) total contracts at 1.84.  
10% of 25 contracts (which is the sell order) execute = 2.5, rounds down to 2 contracts.  
Order 2 represents 10 of 100 (10%) total contracts at 1.84.  
10% of 25 contracts (which is the sell order) execute = 2.5, rounds down to 2 contracts.  
MM1's quote represents 70 of 100 (70%) total contracts at 1.84.  
Again, 70% of 25 contracts execute = 17.5, rounds down to 17 contracts.  
Order 3 represents 10 of 100 (10%) total contracts at 1.84.  
10% of 25 contracts (which is the sell order) execute = 2.5, rounds down to 2 contracts.  
Total executed: 23. There are 2 residual contracts remaining from the 25 contract sell order.  
The remaining 2 contracts are allocated one at a time based on time as follows:  
Order 1 receives 1 additional residual contract.  
Order 2 receives 1 additional residual contract.  
The 25 contract sell order is now completely executed.

In addition, NASDAQ proposes to adopt two priority overlays. The new subparagraph (C), Priority Overlays Applicable to Size Pro-Rata Execution Algorithm, will provide that the Exchange may apply these priority overlays. NASDAQ plans to implement the Size Pro-Rata execution algorithm with both the Public Customer and Market Maker priority overlays.

The first priority overlay, Public Customer Priority, is proposed to be subparagraph (1)(C)(i). Under this priority overlay, interest at the highest bid and lowest offer shall have priority except that Public Customer orders shall have priority over non-Public Customer orders at the same price. If there are two or more Public Customer orders for the same options series at the same price, priority shall be afforded to such Public Customer orders in the sequence in which they are received by the System. For purposes of this Rule, a Public Customer order does not include a Professional Order. This is substantially similar to BX Options, Chapter VI, Section 10.

The second proposed priority overlay is contained in subparagraph (1)(C)(ii), Market Maker Priority. Under this priority overlay, the highest bid and lowest offer shall have priority except that Options Market Maker orders, after all Public Customer orders have been fully executed in time priority, shall have priority over all other Participant orders at the same price. The Public Customer priority is always a part of the Market Maker Priority overlay and both overlays will always apply to the Size Pro-Rata execution algorithm initially. If there are two or more Options Market Maker quotes and orders for the same options series at the same price, those orders shall be executed based on the Size Pro-Rata execution algorithm. If there are contracts remaining after all Market Maker interest has been fully executed (meaning, Non-Public Customer and Non-Market Maker), such contracts shall be executed based on the Size Pro-Rata execution algorithm.<sup>5</sup>

The following is an example of the Public Customer and Market Maker priority overlays applied to the proposed Size Pro-Rata execution algorithm:

*Example 2:*  
Order 1: Buy 10 contracts for 1.84, Non-MM broker-dealer  
Order 2: Buy 10 contracts for 1.84, Public Customer  
Quote MM1: 1.84 (10) x 1.86 (10)  
Order 3: Buy MM 1.84 (10)  
Sell order received: Sell 21 contracts at 1.84

Execution:

Order 2 allocated 10 contracts because of Public Customer priority  
Quote MM1 represents 10 of 20 (50%) total MM contracts at 1.84. 50% of 11 contracts to execute = 5.5, rounds down to 5 contracts.  
Order 3 represents 10 of 20 (50%) total MM contracts at 1.84. 50% of 11 contracts to execute = 5.5, rounds down to 5 contracts.  
Remaining 1 contract is allocated to MM1 based on time among MMs.  
Order 1 is not executed because Market Makers have priority over non-Market Maker broker-dealers. Order 1 would only be executed if all interest at the Public Customer priority level and the Market Maker level was first completely executed.

In summary, this proposed rule change will allow for a different execution algorithm for NOM. To be clear, two different execution algorithms will not operate in the same option. In addition, when the Size Pro-Rata execution algorithm is selected by NASDAQ, the proposed new priority overlays will be applied first as part of the execution algorithm used to allocate the order. These additional priority overlays are Public Customer priority and Market Maker priority, which will only apply to the Size Pro-Rata execution algorithm. NASDAQ notes that the execution algorithm will be selected and communicated by NASDAQ to NOM Participants. The Public Customer and Market Maker priority overlays will always operate with the Size Pro-Rata execution algorithm.

## 2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act<sup>6</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act<sup>7</sup> in particular, in that it is designed to promote just and equitable principles of trade and to protect investors and the public interest, because it will provide an additional execution algorithm with priority overlays on NOM. This additional execution algorithm with priority overlays should provide Participants with additional choices among the many competing exchanges with regard to their execution needs and strategies, which should promote just and equitable principles of trade. The Exchange believes that adding this flexibility to its rules will allow for greater customization, resulting in enhanced service to its customers and users, which would continue to be a purely objective method for allocating option trades. The Exchange is seeking to create additional incentives for firms

<sup>4</sup> This is substantially similar to BX Options, Chapter VI, Section 10(1)(B).

<sup>5</sup> This is substantially similar to BX Options, Chapter VI, Section 10(1)(C).

<sup>6</sup> 15 U.S.C. 78f(b).

<sup>7</sup> 15 U.S.C. 78f(b)(5).

to provide liquidity on NOM. The Exchange believes that, while the price/time execution algorithm encourages liquidity providers to set the price, the Size Pro-Rata execution algorithm encourages liquidity providers to add size to a bid/offer at a particular price, even if that Participant did not set the price. Rewarding liquidity providers who add size should encourage larger displayed markets, which should, in turn, benefit and protect investors and the public interest. The Exchange believes that the public customer priority overlay is designed to promote just and equitable principles of trade and to protect investors and the public interest, because it recognizes the unique status of customers in the marketplace and the role their orders play in price competition and adding depth to the marketplace. The Exchange believes that the market maker priority overlay is designed to promote just and equitable principles of trade and to protect investors and the public interest, because it strikes a reasonable balance between encouraging vigorous price competition and rewarding market makers for their unique obligations.<sup>8</sup> Overall, the overlays represent a careful balancing by the Exchange of the rewards and obligations of various types of market participants.

With respect to the proposed language in subparagraph (A) respecting the price/time execution algorithm, the Exchange believes that the clarification (that within each price level, if there are two or more quotes or orders at the best price, trading interest will be executed in time priority) is designed to promote just and equitable principles of trade and to protect investors and the public interest by making the rule clearer and structured in a way that is user-friendly.

*(B) Self-Regulatory Organization's Statement on Burden on Competition*

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. With respect to inter-market competition, the proposal should enhance NOM's competitive position, as NOM competes vigorously with many other options exchanges. With respect to intra-market competition, the Exchange believes that the proposal will encourage liquidity providers to compete based on the size of their bids/offers. The Exchange does not believe that this will impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Act, because the size

pro-rata allocation algorithms are prevalent on options exchanges, and liquidity providers can also choose to operate on price/time exchanges instead.

*(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others*

No written comments were either solicited or received.

**III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

Because the foregoing proposed rule change does not: (i) Significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A)(ii) of the Act<sup>9</sup> and subparagraph (f)(6) of Rule 19b-4 thereunder.<sup>10</sup>

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is: (i) Necessary or appropriate in the public interest; (ii) for the protection of investors; or (iii) otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or disapproved.

**IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

*Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>) or

Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASDAQ-2013-156 on the subject line.

<sup>9</sup> 15 U.S.C. 78s(b)(3)(a)(ii).

<sup>10</sup> 17 CFR 240.19b-4(f)(6). In addition, Rule 19b-4(f)(6) requires a self-regulatory organization to give the Commission written notice of its intent to file the proposed rule change at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. The Exchange has satisfied this requirement.

*Paper Comments*

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2013-156. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASDAQ-2013-156 and should be submitted on or before January 21, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>11</sup>

**Kevin M. O'Neill,**

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<sup>8</sup> See NOM Rules, Chapter VII, Sections 5 and 6.

<sup>11</sup> 17 CFR 200.30-3(a)(12).