

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-69339; File No. SR-NYSEMKT-2013-10]

### Self-Regulatory Organizations; NYSE MKT LLC; Order Approving, on an Accelerated Basis, Proposed Rule Change, as Modified by Amendment No. 1, Adopting Exchange Rule 953.1NY To Provide for How the Exchange Proposes To Treat Orders, Market-Making Quoting Obligations, and Errors in Response to the Regulation NMS Plan To Address Extraordinary Market Volatility; and Amending Exchange Rule 953NY To Codify That the Exchange Shall Halt Trading in All Options Overlying NMS Stocks When the Equities Markets Initiate a Market-Wide Trading Halt Due to Extraordinary Market Volatility

April 8, 2013.

#### I. Introduction

On February 26, 2013, NYSE MKT LLC (the “Exchange” or “NYSE MKT”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) <sup>1</sup> of the Securities Exchange Act of 1934 (“Act”),<sup>2</sup> and Rule 19b-4 thereunder,<sup>3</sup> a proposed rule change to provide for how the Exchange proposes to treat orders, market-making quoting obligations, and errors in response to the Regulation NMS Plan to Address Extraordinary Market Volatility and to codify that the Exchange shall halt trading in all options overlying NMS stocks when the equities markets initiate a market-wide trading halt due to extraordinary market volatility. The proposed rule change was published for comment in the *Federal Register* on March 4, 2013.<sup>4</sup> On April 1, the Exchange submitted Amendment No. 1 to the proposed rule change.<sup>5</sup> The Commission received one comment letter on the proposal.<sup>6</sup> This order

approves the proposed rule change on an accelerated basis.

#### II. Background

On May 6, 2010, the U.S. equity markets experienced a severe disruption that, among other things, resulted in the prices of a large number of individual securities suddenly declining by significant amounts in a very short time period before suddenly reversing to prices consistent with their pre-decline levels.<sup>7</sup> This severe price volatility led to a large number of trades being executed at temporarily depressed prices, including many that were more than 60% away from pre-decline prices. One response to the events of May 6, 2010, was the development of the single-stock circuit breaker pilot program, which was implemented through a series of rule filings by the equity exchanges and by FINRA.<sup>8</sup> The single-stock circuit breaker was designed to reduce extraordinary market volatility in NMS stocks by imposing a five-minute trading pause when a trade was executed at a price outside of a specified percentage threshold.<sup>9</sup>

To replace the single-stock circuit breaker pilot program, the equity exchanges filed a National Market System Plan <sup>10</sup> pursuant to Section 11A

<sup>7</sup> The events of May 6 are described more fully in a joint report by the staffs of the Commodity Futures Trading Commission (“CFTC”) and the Commission. See Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, “Findings Regarding the Market Events of May 6, 2010,” dated September 30, 2010, available at <http://www.sec.gov/news/studies/2010/marketevents-report.pdf>.

<sup>8</sup> For further discussion on the development of the single-stock circuit breaker pilot program, see Securities Exchange Act Release No. 67091 (May 31, 2012), 77 FR 33498 (June 6, 2012) (“Limit Up-Limit Down Plan” or “Plan”).

<sup>9</sup> See Securities Exchange Act Release Nos. 62884 (September 10, 2010), 75 FR 56618 (September 16, 2010) and Securities Exchange Act Release No. 62883 (September 10, 2010), 75 FR 56608 (September 16, 2010) (SR-FINRA-2010-033) (describing the “second stage” of the single-stock circuit breaker pilot) and Securities Exchange Act Release No. 64735 (June 23, 2011), 76 FR 38243 (June 29, 2011) (describing the “third stage” of the single-stock circuit breaker pilot).

<sup>10</sup> NYSE Euronext filed on behalf of New York Stock Exchange LLC (“NYSE”), NYSE Amex LLC (“NYSE Amex”), and NYSE Arca, Inc. (“NYSE Arca”), and the parties to the proposed National Market System Plan, BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Board Options Exchange, Incorporated (“CBOE”), Chicago Stock Exchange, Inc., EDGA Exchange, Inc., EDGX Exchange, Inc., Financial Industry Regulatory Authority, Inc., NASDAQ OMX BX, Inc., NASDAQ OMX PHLX LLC, the Nasdaq Stock Market LLC, and National Stock Exchange, Inc. (collectively with NYSE, NYSE MKT, and NYSE Arca, the “Participants”). On May 14, 2012, NYSE Amex filed a proposed rule change on an immediately effective basis to change its name to NYSE MKT LLC (“NYSE MKT”). See Securities Exchange Act Release No. 67037 (May 21, 2012) (SR-NYSEAmex-2012-32).

of the Act,<sup>11</sup> and Rule 608 thereunder,<sup>12</sup> which featured a “limit up-limit down” mechanism (as amended, the “Limit Up-Limit Down Plan” or “Plan”).

The Plan sets forth requirements that are designed to prevent trades in individual NMS stocks from occurring outside of the specified price bands. The price bands consist of a lower price band and an upper price band for each NMS stock. When one side of the market for an individual security is outside the applicable price band, i.e., the National Best Bid is below the Lower Price Band, or the National Best Offer is above the Upper Price band, the Processors <sup>13</sup> are required to disseminate such National Best Bid or National Best Offer <sup>14</sup> with a flag identifying that quote as non-executable. When the other side of the market reaches the applicable price band, i.e., the National Best Offer reaches the lower price band, or the National Best Bid reaches the upper price band, the market for an individual security enters a 15-second Limit State, and the Processors are required to disseminate such National Best Offer or National Best Bid with an appropriate flag identifying it as a Limit State Quotation. Trading in that stock would exit the Limit State if, within 15 seconds of entering the Limit State, all Limit State Quotations were executed or canceled in their entirety. If the market does not exit a Limit State within 15 seconds, then the Primary Listing Exchange will declare a five-minute trading pause, which is applicable to all markets trading the security.

The Primary Listing Exchange may also declare a trading pause when the stock is in a Straddle State, i.e., the National Best Bid (Offer) is below (above) the Lower (Upper) Price Band and the NMS Stock is not in a Limit State. In order to declare a trading pause in this scenario, the Primary Listing Exchange must determine that trading in that stock deviates from normal trading characteristics such that declaring a trading pause would support the Plan’s goal to address extraordinary market volatility.<sup>15</sup>

<sup>11</sup> 15 U.S.C. 78k-1.

<sup>12</sup> 17 CFR 242.608.

<sup>13</sup> As used in the Plan, the Processor refers to the single plan processor responsible for the consolidation of information for an NMS Stock pursuant to Rule 603(b) of Regulation NMS under the Exchange Act. See *id.*

<sup>14</sup> “National Best Bid” and “National Best Offer” has the meaning provided in Rule 600(b)(42) of Regulation NMS under the Exchange Act. See *id.*

<sup>15</sup> As set forth in more detail in the Plan, all trading centers would be required to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the display of offers below the Lower Price Band and

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

<sup>2</sup> 15 U.S.C. 78a.

<sup>3</sup> 17 CFR 240.19b-4.

<sup>4</sup> See Securities Exchange Act Release No. 69033, 78 FR 15067 (March 8, 2013).

<sup>5</sup> In Amendment No. 1, the Exchange expanded upon its rationale for its proposed changes regarding the nullification and adjustment of options transactions, agreed to provide the Commission with relevant data to assess the impact of the proposal, and clarified the length of the pilot period related to such changes. Because the changes made in Amendment No. 1 do not materially alter the substance of the proposed rule change or raise any novel regulatory issues, Amendment No. 1 is not subject to notice and comment.

<sup>6</sup> See Letter to Elizabeth M. Murphy, Secretary, Commission, from Janet McGinness, Executive Vice President and Corporate Secretary, General Counsel, NYSE Markets, dated April 5, 2013 (“NYSE Letter”).

On May 31, 2012, the Commission approved the Plan as a one-year pilot, which shall be implemented in two phases.<sup>16</sup> The first phase of the Plan shall be implemented beginning April 8, 2013.<sup>17</sup>

### III. Description of the Proposal

#### 1. Treatment of Market and Stop Orders

The Exchange proposes to adopt new Exchange Rule 953.1NY to provide for how the Exchange shall treat orders and quotes in options overlying NMS if the underlying NMS stock is in a Limit State and Straddle State. Specifically, the Exchange proposes that if the underlying NMS stock is in a Limit State or Straddle State, the Exchange shall reject all incoming Market Orders and will not elect Stop Orders.<sup>18</sup> According to the Exchange, when the underlying enters a Limit or Straddle State, there may not be a reliable underlying reference price, there may be a wide bid/ask quotation differential in the option, and there may be less liquidity in the options markets. For these reasons, the Exchange stated that permitting these order types to execute when the underlying NMS stock is in a Limit or Straddle State could lead to executions at prices that may inferior to the NBBO immediately before the underlying entered the Limit or Straddle State, and could add to volatility in the

bids above the Upper Price Band for an NMS Stock. The Processors would be able to disseminate an offer below the Lower Price Band or bid above the Upper Price Band that nevertheless may be inadvertently submitted despite such reasonable policies and procedures, but with an appropriate flag identifying it as non-executable; such bid or offer would not be included in National Best Bid or National Best Offer calculations. In addition, all trading centers would be required to develop, maintain, and enforce policies and procedures reasonably designed to prevent trades at prices outside the price bands, with the exception of single-priced opening, reopening, and closing transactions on the Primary Listing Exchange.

<sup>16</sup> See "Limit Up-Limit Down Plan," *supra* note 8. See also Securities Exchange Act Release No. 68953 (February 20, 2013), 78 FR 13113 (February 26, 2013) (Second Amendment to Limit Up-Limit Down Plan by BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Board Options Exchange, Inc., *et al.*) and Securities Exchange Act Release No. 69062 (March 7, 2013), 78 FR 15757 (March 12, 2013) (Third Amendment to Limit Up-Limit Down Plan by BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Board Options Exchange, Inc., *et al.*)

<sup>17</sup> See "Second Amendment to Limit Up-Limit Down Plan," *supra* note 16.

<sup>18</sup> See Rule 900.3NY(d)(1). Stop Orders when elected create a Market Order to buy or sell the option. In contrast, the Exchange is not proposing to prohibit the election of Stop Limit Orders. Stop Limit Orders when elected create a Limit Order to buy or sell the option at a specific price. See 900.3NY(d)(2). The Exchange represented that Stop Limit Orders do not raise the same risks during periods of extraordinary volatility, because once elected the associated limit orders would not race through the order book in the manner that an elected Market Order would.

options markets during times of extraordinary market volatility.

#### 2. Specialist and Market Maker Quoting Obligations

The Exchange also proposes to modify its rules governing quoting obligations for Specialists and Market Makers. Specifically, the Exchange will provide that, when evaluating whether a Specialist has met its market-making quoting requirement pursuant to Rule 925.1NY(b) or a Market Maker has met its market-making quoting requirement pursuant to Rule 925.1NY(c) in options overlying NMS stocks, the Exchange shall consider as a mitigating circumstance the frequency and duration of occurrences when an underlying NMS stock is in a Limit State or a Straddle State. For example, if a Market Maker failed to meet its monthly quoting obligations, and during the review, it was determined that the quoting that failed to meet the obligation was for options on NMS stocks with a significant number of Straddle States and Limit States, then pursuant to proposed Rule 953.1NY(c), that would be considered a mitigating circumstance that would entitle that Market Maker to relief.

The Exchange represented that this change is necessary given the direct relationship between the price of an option and the price of the underlying security, which may affect the quoting behavior of Specialists and Market Makers. For example, when the underlying is in a Limit or Straddle State, the ability of a Specialist or Market Maker to hedge an options position may be impaired, and they modify their quoting behavior accordingly. The Exchange also stated that this aspect of its proposal would facilitate transactions and preserve market liquidity.

#### 3. Declaration of Trading Halts

The Exchange also proposes to amend Rule 953NY so that the Exchange would halt trading in all options whenever the equities markets halt trading in all NMS stocks due to extraordinary market volatility, i.e., when a market-wide circuit breaker is triggered.<sup>19</sup> The Exchange noted that this provision, which explicitly provides for a trading halt when the equities market is halted

<sup>19</sup> Market-wide circuit breakers in the equities market are different than a trading halt during a Trading Pause in the underlying pursuant to the LULD Plan. Market-wide circuit breakers for equities are currently covered by NYSE MKT Rule 80B—Equities. See NYSE MKT Rule 80B—Equities. The Exchange's Rule regarding trading pauses (also known as "single stock circuit breakers") is found in Rule 953NY(b) for options and NYSE MKT Rule 80C(b)—Equities for equities.

due to the market-wide circuit breaker, is similar to a rule recently amended by CBOE.<sup>20</sup> The Exchange also represented that the remaining provisions in existing Rule 953NY regarding Trading Halts and Suspensions remain unchanged and provide a means to halt or suspend trading in options contracts whenever the Exchange deems such action appropriate in the interests of a fair and orderly market and to protect investors.

In addition, the Exchange is proposing to add Commentary .05 to provide that reopening of trading following a trading halt under this Rule shall be conducted pursuant to procedures adopted by the Exchange and communicated by notice to its ATP Holders and ATP Firms. The Exchange represented this Commentary is similar to that found in CBOE Rule 6.3B, and nearly identical to Commentary .03 to NYSE Arca Options Rule 7.5.<sup>21</sup>

#### 4. Obvious Error

In connection with the implementation of the Plan, the Exchange proposes to adopt new Rule 953.1NY(c) to exclude electronic transactions in stock options that overlay an NMS stock that occur during a Limit State or Straddle State from the provisions of Rule 975NY(a) for Obvious Errors or Rule 975NY(d) for Catastrophic Errors. Additionally, the Exchange proposes to retain the ability to review electronic transactions that occur during a Limit State or Straddle State by Exchange motion pursuant to Rule 975NY(b)(3).<sup>22</sup>

<sup>20</sup> See CBOE Rule 6.3B.

<sup>21</sup> See CBOE Rule 6.3B and NYSE Arca Options Rule 7.5.

<sup>22</sup> Rule 975NY(b)(3) provides that in the interest of maintaining a fair and orderly market and for the protection of investors, the Exchange's Chief Executive Officer ("CEO") or designee thereof, who is an officer of the Exchange (collectively "Exchange officer"), may, on his or her own motion or upon request, determine to review any transaction occurring on the Exchange that is believed to be erroneous. A transaction reviewed pursuant to this provision may be nullified or adjusted only if it is determined by the Exchange officer that the transaction is erroneous as provided in Rule 975NY(a)(3), (a)(4), (a)(5) or (a)(6). A transaction would be adjusted or nullified in accordance with the provision under which it is deemed an erroneous transaction. The Exchange officer may be assisted by a Trading Official in reviewing a transaction. In addition, the Exchange officer shall act pursuant to 975NY(b)(3) as soon as possible after receiving notification of the transaction, and ordinarily would be expected to act on the same day as the transaction occurred. In no event shall the Exchange officer act later than 9:30 a.m. (ET) on the next trading day following the date of the transaction in question. An ATP Holder affected by a determination to nullify or adjust a transaction pursuant to this paragraph (3) may appeal such determination in accordance with Rule 975NY(c); however, a determination by an Exchange officer not to review a transaction, or a determination not to nullify or adjust a transaction

Rule 975NY provides a process by which a transaction may be nullified or adjusted when the execution price of a transaction deviates from the option's theoretical price by a certain amount. Generally, the theoretical price of an option is the National Best Bid and Offer ("NBBO") of the option. In certain circumstances, Trading Officials have the discretion to determine the theoretical price.<sup>23</sup>

The Exchange believes maintaining the current operation of Rules 975NY(a)(1) and 975NY(d)(1) during a Limit State or Straddle State would be undesirable. According to the Exchange, during periods of extraordinary volatility, the review period<sup>24</sup> for transactions under the Obvious Error and Catastrophic Error provisions would allow market participants to re-evaluate a transaction that occurred during a Limit State or Straddle State at a later time, which is potentially unfair to other market participants and would discourage market participants from providing liquidity during Limit States or Straddle States. The Exchange believes that market participants should not be able to benefit from the time frame to review their transactions in these situations.

The Exchange also noted that, barring this proposed rule change, the provisions of Rules 975NY(a)(2)(B) and 975NY(d)(2)(B)<sup>25</sup> would likely apply in many instances during Limit or Straddle States. The Exchange believes this provision would give rise to much uncertainty for market participants as there is no bright line definition of what the theoretical value should be for an

option when the underlying NMS stock has an unexecutable bid or offer or both. The Exchange notes that the theoretical price in this context would be subjective. Ultimately, the Exchange believes that adding certainty to the execution of orders in these situations should encourage market participants to continue to provide liquidity to the Exchange, thus promoting fair and orderly markets.

In Amendment No. 1, the Exchange also noted that application of current Rules 975NY(a) and 975NY(d) would be unreliable during a Limit State or Straddle State. The Exchange believes that application of Rules 975NY(a) and 975NY(d) to electronic transactions occurring during a Limit or Straddle State would be impracticable given the lack of a reliable national best bid or offer in the options market during Limit States and Straddle States and that the resulting actions may not be appropriate given market conditions. On balance, the Exchange believes that removing the potential inequity of nullifying or adjusting executions occurring during Limit States or Straddle States outweighs any potential benefits from applying Rules 975NY(a) and 975NY(d) during such unusual market conditions.

In response to these concerns, the Exchange proposes to adopt Rule 953.1NY(c) to provide that electronic transactions are not subject to an obvious error or catastrophic error review pursuant to Rules 975NY(a) and 975NY(d) during a Limit State or Straddle State.

Proposed Rule 953.1NY(c) will also include a qualification that nothing in the proposed rule change will prevent electronic trades from being reviewed on Exchange motion pursuant to Rule 975NY(b)(3).<sup>26</sup> According to the Exchange, this safeguard will provide the flexibility to act when necessary and appropriate, while also providing market participants with certainty that trades they effect with quotes and/or orders having limit prices will stand irrespective of subsequent moves in the underlying security. The right to review on Exchange motion electronic transactions that occur during a Limit State or Straddle State under this provision, according to the Exchange, would enable the Exchange to account for unforeseen circumstances that result in obvious or catastrophic errors for which a nullification or adjustment may be necessary in order to preserve the interest of maintaining a fair and orderly

market and for the protection of investors.

The Exchange also noted that its existing order protections that reject limit orders that are priced too far through the NBBO would continue to apply during Limit and Straddle States. Additionally, the Exchange notes that while in Limit States and Straddle States, only limit orders will be accepted, affirming that the participant is willing to accept an execution up to the limit price. Further, according to the Exchange, the Exchange system will only trade through the theoretical bid or offer if the Exchange or the participant (via an ISO order) has accessed all better priced interest away in accordance with the Options Order Protection and Locked/Crossed Markets Plan. The Exchange believes potential trade reviews of executions that occurred at the participant's limit price in compliance with the aforementioned Plan could harm liquidity and also create an advantage to either side of an execution depending on the future movement of the underlying stock.

#### IV. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and rules and regulations thereunder applicable to a national securities exchange.<sup>27</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>28</sup> which, among other things, requires a national securities exchange to be so organized and have the capacity to be able to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its members with the provisions of the Act, the rules and regulations thereunder, and the rules of the exchange, and is 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 regulation, 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 public interest.

With respect to the proposal to reject market orders and to not elect Stop Orders when the underlying is in a

for which a review was requested or conducted, is not appealable. If a transaction is reviewed and a determination is rendered pursuant to Rules 975NY(a)(3), (a)(4), (a)(5) or (a)(6), no additional relief may be granted under this provision.

<sup>23</sup> Specifically, under Rules 975NY(a)(2) and 975NY(d)(2), the theoretical price is determined in one of two ways: (i) If the series is traded on at least one other options exchange, the last bid price with respect to an erroneous sell transaction and the last offer price with respect to an erroneous buy transaction, just prior to the trade, that comprise the NBBO as disseminated by the Options Price Reporting Authority; or (ii) as determined by a designated Trading Official, if there are not quotes for comparison purposes, or if the bid/ask differential of the NBBO for the affected series just prior to the erroneous transaction was at least two times the permitted bid/ask differential pursuant to Rule 925NY(b)(4).

<sup>24</sup> Pursuant to Rule 975NY(b), market participants may have up to 20 minutes to notify the Exchange of a transaction that may be an Obvious Error. Pursuant to Rule 975NY(d), market participants may have up to 8:30 a.m. ET on the first trading day following a transaction to review it as a Catastrophic Error.

<sup>25</sup> These provisions give the Exchange Trading Official the discretion to determine the theoretical price of an option for purposes of analyzing whether a transaction qualifies for nullification or adjustment under Rule 975NY.

<sup>26</sup> The Exchange stated that it received informal feedback from a number of market participants, including liquidity providers and order flow providers, that has generally been supportive of the Exchange's proposed rule change.

<sup>27</sup> In approving the proposed rule changes, the Commission has considered their impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>28</sup> 15 U.S.C. 78f(b).

Limit or Straddle State, the Exchange stated that permitting these order types to execute during these times could contribute to market volatility and could have the potential to lead to poor executions, as spreads in the options markets might have widened in response to the underlying entering a Limit or Straddle State. The Commission believes that rejecting market orders and not electing Stop Orders during these times will provide certainty to the treatment of Market Orders and Stop Orders during these times. To the extent that the spreads in the options market may widen as a result of the underlying entering a Limit or Straddle State, this proposal may also prevent market and Stop Orders from receiving executions at unintended prices during these times.

With respect to deeming the frequency and duration with which the underlying security is in a Limit or Straddle State a mitigating circumstance when evaluating the adherence of Specialists and Market Makers to their respective quoting obligations, the Commission finds that this proposal represents an appropriate response to the potential effect on the options markets of the underlying entering a Limit or Straddle State. During a limit up-limit down state, there may not be a reliable price for the underlying security to serve as a benchmark for market makers to price options. In addition, the absence of an executable bid or offer for the underlying security will make it more difficult for market makers to hedge the purchase or sale of an option. Given these significant changes to the normal operating conditions of market makers, the Commission finds that the Exchange's proposal in these limited circumstances is consistent with the Act.

The Commission notes, however, that the Plan was approved on a pilot basis and its Participants will monitor how it is functioning in the equity markets during the pilot period. To this end, the Commission expects that, upon implementation of the Plan, the Exchange will continue monitoring this amendment to its rules and determine if any necessary adjustments are required to ensure that they remain consistent with the Act.

The Commission also believes that the proposal to halt trading in the options market when trading in the equities markets has been halted as a result of the market-wide circuit breaker being triggered is consistent with the Act. This proposal is reasonably designed to ensure that the Exchange halts trading in all options whenever the equities markets initiate a trading halt as a result

of the market-wide circuit breaker, thereby minimizing volatility in the options markets. This provision is also similar to a corresponding CBOE rule. The provision addressing re-opening of trading following such a halt is substantively similar to both CBOE Rule 6.3B, and the commentary contained in NYSE Arca Rule 7.5.

The Commission finds that the Exchange's proposal to suspend certain aspects of Rule 975NY during a Limit State or Straddle State is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>29</sup> Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,<sup>30</sup> in that it is designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, protect investors and the public interest.

In Amendment No. 1, the Exchange notes its belief that suspending certain aspects of Rule 975NY during a Limit State or Straddle State will ensure that limit orders that are filled during a Limit or Straddle State will have certainty of execution in a manner that promotes just and equitable principles of trade and removes impediments to, and perfects the mechanism of, a free and open market and a national market system. The Exchange states that it believes the application of the current rule would be impracticable given what it perceives will be the lack of a reliable NBBO in the options market during Limit States and Straddle States, and that the resulting actions (*i.e.*, nullified trades or adjusted prices) may not be appropriate given market conditions. In addition, given the Exchange's view that options prices during Limit States or Straddle States may deviate substantially from those available shortly following the Limit State or Straddle State, the Exchange believes that providing market participants time to re-evaluate a transaction executed during a Limit or Straddle State will create an unreasonable adverse selection opportunity that will discourage

participants from providing liquidity during Limit States or Straddle States. Ultimately, the Exchange believes that adding certainty to the execution of orders in these situations should encourage market participants to continue to provide liquidity to the Exchange during Limit States and Straddle States, thus promoting fair and orderly markets.

The Commission notes, however, that the Exchange has proposed this rule change based on its expectations about the quality of the options market during Limit States and Straddle States. In Amendment No. 1, the Exchange stated, for example, that it believes that application of the obvious and catastrophic error rules would be impracticable given the potential for lack of a reliable NBBO in the options market during Limit States and Straddle States. Given the Exchange's recognition of the potential for unreliable NBBOs in the options markets during Limit States and Straddle States, the Commission is concerned about the extent to which investors may rely to their detriment on the quality of quotations and price discovery in the options markets during these periods. This concern is heightened by the Exchange's proposal to exclude trades that occur during a Limit State or Straddle State from the obvious error or catastrophic error review procedures pursuant to Rules 975NY(a) or 975NY(d). The Commission urges investors and market professionals to exercise caution when considering trading options under these circumstances. Broker-dealers also should be mindful of their obligations to customers that may or may not be aware of specific options market conditions or the underlying stock market conditions when placing their orders.

While the Commission remains concerned about the quality of the options market during the Limit and Straddle States, and the potential impact on investors of executing in this market without the protections of the obvious or catastrophic error rules that are being suspended during the Limit and Straddle States, it believes that certain aspects of the proposal could help mitigate those concerns.

First, despite the removal of obvious and catastrophic error protection during Limit States and Straddle States, the Exchange states that there are additional measures in place designed to protect investors. For example, the Exchange states that by rejecting market orders and stop orders, and cancelling pending market orders and stop orders, only those orders with a limit price will be executed during a Limit State or Straddle State. Additionally, the

<sup>29</sup> 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).

<sup>30</sup> 15 U.S.C. 78f(b)(5).

Exchange notes the existence of SEC Rule 15c3-5 requiring broker-dealers to have controls and procedures in place that are reasonably designed to prevent the entry of erroneous orders. Finally, with respect to limit orders that will be executable during Limit States and Straddle States, the Exchange states that it applies price checks to limit orders that are priced sufficiently far through the NBBO. Therefore, on balance, the Exchange believes that removing the potential inequity of nullifying or adjusting executions occurring during Limit States or Straddle States outweighs any potential benefits from applying certain provisions during such unusual market conditions.

The Exchange also believes that the aspect of the proposed rule change that will continue to allow the Exchange to review on its own motion electronic trades that occur during a Limit State or a Straddle State is consistent with the Act because it would provide flexibility for the Exchange to act when necessary and appropriate to nullify or adjust a transaction and will enable the Exchange to account for unforeseen circumstances that result in obvious or catastrophic errors for which a nullification or adjustment may be necessary in order to preserve the interest of maintaining a fair and orderly market and for the protection of investors. In Amendment No. 1, the Exchange represents that it recognizes that this provision is limited and that it will administer the provision in a manner that is consistent with the principles of the Act. In addition, the Exchange represents that it will create and maintain records relating to the use of the authority to act on its own motion during a Limit State or Straddle State.

Finally, the Exchange has proposed that the changes be implemented on a one year pilot basis. The Commission believes that it is important to implement the proposal as a pilot. The one year pilot period will allow the Exchange time to assess the impact of the Plan on the options marketplace and allow the Commission to further evaluate the effect of the proposal prior to any proposal or determination to make the changes permanent. To this end, pursuant to Amendment No. 1, the Exchange has committed to: (1) Evaluate the options market quality during Limit States and Straddle States; (2) assess the character of incoming order flow and transactions during Limit States and Straddle States; and (3) review any complaints from members and their customers concerning executions during Limit States and Straddle States. Additionally, the Exchange has agreed to provide to the Commission with data

requested to evaluate the impact of the elimination of the obvious error rule, including data relevant to assessing the various analyses noted above. On April 5, 2013, NYSE Euronext submitted a letter on behalf of the Exchange, stating that the Exchange will provide specific data to the Commission and the public and certain analysis to the Commission to evaluate the impact of Limit States and Straddle States on liquidity and market quality in the options markets.<sup>31</sup> This will allow the Commission, the Exchange, and other interested parties to evaluate the quality of the options markets during Limit States and Straddle States and to assess whether the additional protections noted by the Exchange are sufficient safeguards against the submission of erroneous trades, and whether the Exchange's proposal appropriately balances the protection afforded to an erroneous order sender against the potential hazards associated with providing market participants additional time to

<sup>31</sup> In particular, the Exchange represented that, at least two months prior to the end of the one year pilot period of proposed Rule 953.1NY(c), it would provide to the Commission an evaluation of (i) the statistical and economic impact of Straddle States on liquidity and market quality in the options market and (ii) whether the lack of obvious error rules in effect during the Limit States and Straddle States are problematic. In addition, the Exchange represented that each month following the adoption of the proposed rule change it would provide to the Commission and the public a dataset containing certain data elements for each Limit State and Straddle State in optionable stocks. The Exchange stated that the options included in the dataset will be those that meet the following conditions: (i) The options are more than 20% in the money (strike price remains greater than 80% of the last stock trade price for calls and strike price remains greater than 120% of the last stock trade price for puts when the Limit State or Straddle State is reached); (ii) the option has at least two trades during the Limit State or Straddle State; and (iii) the top ten options (as ranked by overall contract volume on that day) meeting the conditions listed above. For each of those options affected, each dataset will include, among other information: Stock symbol, option symbol, time at the start of the Limit State or Straddle State and an indicator for whether it is a Limit State or Straddle State. For activity on the Exchange in the relevant options, the Exchange has agreed to provide executed volume, time-weighted quoted bid-ask spread, time-weighted average quoted depth at the bid, time-weighted average quoted depth at the offer, high execution price, low execution price, number of trades for which a request for review for error was received during Limit States and Straddle States, an indicator variable for whether those options outlined above have a price change exceeding 30% during the underlying stock's Limit State or Straddle State compared to the last available option price as reported by OPRA before the start of the Limit or Straddle state (1 if observe 30% and 0 otherwise), and another indicator variable for whether the option price within five minutes of the underlying stock leaving the Limit State or Straddle State (or halt if applicable) is 30% away from the price before the start of the Limit State or Straddle State. See NYSE Letter, *supra* note 5.

review trades submitted during a Limit State or Straddle State.

In addition, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act<sup>32</sup> for approving the proposed rule change on an accelerated basis. This proposal is related to the Plan, which will become operative on April 8, 2013, and aspects of the proposal, such as rejecting market orders and not electing Stop Orders during the Limit and Straddle States, are designed to prevent such orders from receiving poor executions during those times.<sup>33</sup> In granting accelerated approval, the proposed rule change, and any attendant benefits, will take effect upon the Plan's implementation date. Accordingly, the Commission finds that good cause exists for approving the proposed rule change on an accelerated basis.

## V. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act<sup>34</sup> that the proposed rule change (SR-NYSEMKT-2013-10) is approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>35</sup>

**Kevin M. O'Neill,**  
Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-69331; File No. SR-BATS-2013-016]

### Self-Regulatory Organizations; BATS Exchange, Inc.; Order Approving, on an Accelerated Basis, Proposed Rule Change To Modify the BATS Options Market Maker Obligation Rule

April 5, 2013.

## I. Introduction

On March 1, 2013, BATS Exchange, Inc. (the "Exchange" or "BATS") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1)<sup>1</sup> of the Securities Exchange Act of 1934 ("Act"),<sup>2</sup> and Rule 19b-4 thereunder,<sup>3</sup> a proposed rule change to modify the BATS Options Market ("BATS Options") Market Maker

<sup>32</sup> 15 U.S.C. 78s(b)(2)

<sup>33</sup> See *supra* note 17.

<sup>34</sup> 15 U.S.C. 78f(b)(2).

<sup>35</sup> 17 CFR 200.30-3(a)(12).

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

<sup>2</sup> 15 U.S.C. 78a.

<sup>3</sup> 17 CFR 240.19b-4.