

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-79996; File Nos. SR-BX-2016-068; SR-NASDAQ-2016-169; SR-Phlx-2016-120)

February 9, 2017

Self-Regulatory Organizations; NASDAQ BX, Inc.; The Nasdaq Stock Market LLC; NASDAQ PHLX LLC; Order Granting Approval of Proposed Rule Changes, as Modified by Amendment No. 1s, To Accept Orders Routed Inbound from the International Stock Exchange, LLC, ISE Gemini, LLC, and ISE Mercury, LLC, by Nasdaq Execution Services, LLC

I. Introduction

On December 9, 2016, NASDAQ BX, Inc. (“BX”), The NASDAQ Stock Market LLC (“Nasdaq”), and NASDAQ PHLX LLC (“Phlx” and, each of BX, Nasdaq, and Phlx a “NASDAQ Exchange” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), 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> proposed rule changes to permit BX, Phlx, and The NASDAQ Options Market LLC (“NOM”)<sup>3</sup> to accept options orders routed inbound from the International Stock Exchange, LLC (“ISE”), ISE Gemini, LLC (“ISE Gemini”), and ISE Mercury, LLC (“ISE Mercury” and, together with ISE and ISE Gemini, the “ISE Exchanges”) by Nasdaq Execution Services, LLC (“NES”), an affiliate of both the NASDAQ Exchanges and the ISE Exchanges

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

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

<sup>3</sup> NOM is a facility of Nasdaq. See Nasdaq Options Rules, Chapter I, Section 1(a)(28).

(the NASDAQ Exchanges, together with the ISE Exchanges, the “Affiliated Exchanges”).<sup>4</sup> On December 20, 2016, each of the NASDAQ Exchanges filed an Amendment No. 1 to its respective proposed rule change. The proposed rule changes, each as modified by Amendment No. 1 thereto, were published for comment in the Federal Register on December 29, 2016.<sup>5</sup> The Commission received no comments on the proposals. This order approves the proposed rule changes, as modified by their respective Amendment No. 1s.

## II. Background

Phlx Rule 985(b)(i)(A) prohibits Phlx or any entity with which it is affiliated from, directly or indirectly, acquiring or maintaining an ownership interest in, or engaging in a business venture with, an Exchange member or an affiliate of an Exchange member in the absence of an effective filing under Section 19(b) of the Act.<sup>6</sup> Nasdaq’s and BX’s rules include

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<sup>4</sup> The ISE Exchanges submitted related proposed rule changes that, among other things, would permit each ISE Exchange to use NES to route options orders outbound to away markets. See Securities Exchange Act Release Nos. 79665 (December 22, 2016), 81 FR 96092 (December 29, 2016) (SR-ISE-2016-27); 79664 (December 22, 2016), 81 FR 96136 (December 29, 2016) (SR-ISEGemini-2016-16); and 79663 (December 22, 2016), 81 FR 96089 (December 29, 2016) (SR-ISEMercury-2016-22). The Commission is also today approving these proposed rules changes. See Securities Exchange Act Release Nos. 79994 (February 9, 2017); and 79995 (February 9, 2017) (“ISE Exchange Routing Orders”).

<sup>5</sup> See Securities Exchange Act Release Nos. 79661 (December 22, 2016), 81 FR 96100 (SR-BX-2016-068) (“BX Notice”); 79662 (December 22, 2016), 81 FR 96087 (SR-NASDAQ-2016-169) (“Nasdaq Notice”); and 79660 (December 22, 2016), 81 FR 96060 (SR-Phlx-2016-120) (“Phlx Notice”).

<sup>6</sup> 15 U.S.C. 78s(b). Phlx Rule 985 also prohibits a Phlx member from being or becoming an affiliate of Phlx, or an affiliate of an entity affiliated with Phlx, in the absence of an effective filing under Section 19(b) of the Act. See Phlx Rule 958(b)(i)(B).

similar prohibitions.<sup>7</sup> NES is a registered broker-dealer that is a member of NOM,<sup>8</sup> BX,<sup>9</sup> and Phlx,<sup>10</sup> and currently provides to members of each, optional routing services to other markets.<sup>11</sup> NES is owned by Nasdaq, Inc.,<sup>12</sup> which also owns all of the Affiliated Exchanges.<sup>13</sup> Thus, NES is an affiliate of the NASDAQ Exchanges, as well as an affiliate of the ISE Exchanges. Absent an effective filing, the rules of Nasdaq, BX, and Phlx would prohibit NES from being a member of each of those Exchanges. Today, NES is a member of each of the NASDAQ Exchanges and performs certain limited activities for each, pursuant to effective filings pursuant to Section

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<sup>7</sup> Pursuant to Nasdaq Rule 2160(a): “(1) Nasdaq or any entity with which it is affiliated shall not, directly or indirectly, acquire or maintain an ownership interest in, or engage in a business venture with, a Nasdaq member or an affiliate of a Nasdaq member in the absence of an effective filing under Section 19(b) of the Act; and (2) a Nasdaq member shall not be or become an affiliate of Nasdaq, or an affiliate of an entity affiliated with Nasdaq, in the absence of an effective filing under Section 19(b) of the Act.”

Pursuant to BX Rule 2140(a): “(1) [BX] or any entity with which it is affiliated shall not, directly or indirectly, acquire or maintain an ownership interest in, or engage in a business venture with, [a BX] member or an affiliate of [a BX] member in the absence of an effective filing under Section 19(b) of the Act; and (2) [a BX] member shall not be or become an affiliate of [BX], or an affiliate of an entity affiliated with [BX], in the absence of an effective filing under Section 19(b) of the Act.”

<sup>8</sup> See Nasdaq Notice, supra note 5, at 96087.

<sup>9</sup> See BX Notice, supra note 5, at 96100.

<sup>10</sup> See Phlx Notice, supra note 5, at 96061.

<sup>11</sup> See Phlx Rule 1080(m)(iii); Nasdaq Options Rules, Chapter VI, Section 11(e); and BX Options Rules, Chapter VI, Section 11(e). See also Phlx Notice, supra note 5, at 96061; Nasdaq Notice, supra note 5, at 96087; and BX Notice, supra note 5, at 96100.

<sup>12</sup> See Securities Exchange Act Release No. 69233 (March 25, 2013), 78 FR 19352 (March 29, 2013) (SR-NASDAQ-2013-028) (order approving a proposed rule change to make permanent a pilot program to permit NASDAQ to accept inbound orders routed by NES from the BX Equities market and PSX) at 19352 n.6 and accompanying text.

<sup>13</sup> See Securities Exchange Act Release No. 78119 (June 21, 2016), 81 FR 41611 (June 27, 2016) (SR-ISE-2016-11; SR-ISE Gemini-2016-05; SR-ISE Mercury-2016-10) (order approving a proposed rule change relating to Nasdaq, Inc.’s acquisition of ISE, ISE Gemini, and ISE Mercury).

19(b).<sup>14</sup> Among other activities, each of the NASDAQ Exchanges accepts options orders routed inbound from each of the other NASDAQ Exchanges pursuant to certain limitations and conditions.<sup>15</sup> With the current proposed rule changes, the NASDAQ Exchanges seek approval to permit NES to also route options orders inbound from the ISE Exchanges pursuant to those same limitations and conditions.<sup>16</sup>

### III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule changes, each as modified by Amendment No. 1, are consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>17</sup> Specifically, the Commission finds that

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<sup>14</sup> See, e.g., supra note 11; and Securities Exchange Act Release Nos. 69233, supra note 12; 69232 (March 25, 2013), 78 FR 19342 (March 29, 2013) (SR-BX-2013-013) (order approving a proposed rule change to make permanent a pilot program to permit BX to accept inbound orders routed by NES from PSX); 69229 (March 25, 2013), 78 FR 19337 (March 29, 2013) (SR-Phlx-2013-15) (order approving a proposed rule change to make permanent a pilot program to permit PSX to accept inbound orders routed by NES from BX); 71416 (January 28, 2014), 79 FR 6244 (February 3, 2014) (SR-Phlx-2014-05) (notice of filing and immediate effectiveness of proposed rule change to permit Phlx to receive inbound orders in options routed through NES from NOM and BX); 71420 (January 28, 2014), 79 FR 6256 (February 3, 2014)(SR-BX-2014-004) (notice of filing and immediate effectiveness of proposed rule change to permit BX to receive inbound orders in options routed through NES from NOM and Phlx); and 71418 (January 28, 2014), 79 FR 6262 (February 3, 2014) (SR-NASDAQ-2014-008) (notice of filing and immediate effectiveness of proposed rule change to permit NOM to receive inbound orders in options routed through NES from BX and Phlx).

<sup>15</sup> See Securities Exchange Act Release Nos. 71416, supra note 14; 71420, supra note 14; and 71418, supra note 14. With respect to Nasdaq, routing of options orders is permitted into NOM from BX and Phlx, into Phlx from NOM and BX, and into BX from NOM and Phlx. See id.

<sup>16</sup> See Phlx Notice, supra note 5, at 96062; Nasdaq Notice, supra note 5, at 96088; and BX Notice, supra note 5, at 96101. In the case of Nasdaq, Nasdaq proposes to permit NES to route options orders into NOM. See Nasdaq Notice, supra note 5, at 96087.

<sup>17</sup> In approving these proposed rule changes, the Commission has considered the proposed rules' impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

the proposed rule changes are consistent with Section 6(b)(1) of the Act,<sup>18</sup> which requires, among other things, that a national securities exchange be so organized and have the capacity to carry out the purposes of the Act, and to comply and enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulation thereunder, and the rules of the exchange. Further, the Commission finds that the proposed rule changes are consistent with Section 6(b)(5) of the Act,<sup>19</sup> 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, and 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. Section 6(b)(5) also requires that the rules of an exchange not be designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

For each of the ISE Exchanges, NES will operate as a facility that provides outbound options routing from the respective ISE Exchange to other market centers, subject to certain conditions.<sup>20</sup> The operation of NES as a facility of each of the ISE Exchanges providing outbound routing services will be subject to oversight by each of the ISE Exchanges, respectively, as well as Commission oversight. Each of the ISE Exchanges will be responsible for ensuring that NES's outbound options routing services are operated consistent with Section 6 of the Act and ISE, ISE Gemini, and ISE Mercury's rules, respectively. In addition, the ISE Exchanges must each file with

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<sup>18</sup> 15 U.S.C. 78f(b)(1).

<sup>19</sup> 15 U.S.C. 78f(b)(5).

<sup>20</sup> See ISE Exchange Routing Orders, supra note 4.

the Commission rule changes and fees relating to their outbound options routing services provided by NES.

Recognizing that the Commission has expressed concern regarding the potential for conflicts of interest in instances where a member firm is affiliated with an exchange to which it is routing orders, each NASDAQ Exchange previously implemented limitations and conditions on its affiliation with NES to permit the Exchange to accept inbound options orders that NES routes in its capacity as a facility of the other NASDAQ Exchanges.<sup>21</sup> Again recognizing the concern previously expressed by the Commission, each NASDAQ Exchange now proposes that it be permitted<sup>22</sup> to accept inbound options orders that NES routes in its capacity as a facility of ISE, ISE Gemini, and ISE Mercury, subject to those same limitations and conditions, as follows:<sup>23</sup>

- First, each NASDAQ Exchange and the Financial Industry Regulatory Authority (“FINRA”) will maintain a Regulatory Services Agreement (“RSA”), as well as an agreement pursuant to Rule 17d-2 under the Act (“17d-2 Agreement”).<sup>24</sup> Pursuant to the RSA and the 17d-2 Agreement, FINRA will be allocated regulatory responsibilities to review NES’s compliance with certain Nasdaq, BX, and Phlx rules, respectively.<sup>25</sup>

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<sup>21</sup> See supra note 15 and accompanying text.

<sup>22</sup> In the case of Nasdaq, the Exchange requests that NOM be permitted to accept inbound options orders that NES routes in its capacity as a facility of the ISE Exchanges. See Nasdaq Notice, supra note 5, at 96087.

<sup>23</sup> See Phlx Notice, supra note 5, at 96061; Nasdaq Notice, supra note 5, at 96087-88; BX Notice, supra note 5, at 96101.

<sup>24</sup> 17 CFR 240.17d-2.

<sup>25</sup> NES is also subject to independent oversight by FINRA, its designated examining authority, for compliance with financial responsibility requirements.

Pursuant to the RSA, however, each Exchange retains ultimate responsibility for enforcing its rules with respect to NES.

- Second, FINRA will monitor NES for compliance with each of the Exchange’s trading rules, and will collect and maintain certain related information.<sup>26</sup>
- Third, FINRA will provide a report to each Exchange’s chief regulatory officer (“CRO”), on a quarterly basis, that: (i) quantifies all alerts (of which the Exchange or FINRA is aware) that identify NES as a participant that has potentially violated Commission, or the respective Exchange’s, rules, and (ii) lists all investigations that identify NES as a participant that has potentially violated Commission, or the respective Exchange’s, rules.
- Fourth, Nasdaq, BX, and Phlx each have in place a rule that requires Nasdaq, Inc., as the holding company owning both the Exchange and NES, to establish and maintain procedures and internal controls reasonably designed to ensure that NES does not develop or implement changes to its system, based on non-public information obtained regarding planned changes to the Exchange’s systems as a result of its affiliation with the

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<sup>26</sup> Pursuant to the RSA, both FINRA and the respective Exchange will collect and maintain all alerts, complaints, investigations and enforcement actions in which NES (in its capacity as a facility of each of the ISE Exchanges routing orders to the Exchange) is identified as a participant that has potentially violated applicable Commission or Exchange rules. The respective Exchange and FINRA will retain these records in an easily accessible manner in order to facilitate any potential review conducted by the Commission’s Office of Compliance Inspections and Examinations. See Nasdaq Notice, supra note 5, at 96088 n.12; BX Notice, supra note 5, at 96101 n.12; and Phlx Notice, supra note 5, at 96061 n.12. Each of the NASDAQ Exchanges state that the RSA functions in this manner in connection with NES routing in its capacity as a facility of the other NASDAQ Exchanges, and each now seeks to permit an inbound routing relationship with the ISE Exchanges pursuant to the same conditions. See Phlx Notice, supra note 5, at 96061-62 & n.12; Nasdaq Notice, supra note 5, at 96088 & n.12; and BX Notice, supra note 5, at 96101 & n.12.

Exchange, until such information is available generally to similarly situated Exchange members, in connection with the provision of inbound routing to the Exchange.<sup>27</sup>

Each of the NASDAQ Exchanges has stated that it has met all of the above-listed conditions in connection with NES routing in its capacity as a facility of the other NASDAQ Exchanges, and will comply with these conditions in connection with NES routing in its capacity as a facility of the ISE Exchanges. By meeting such conditions, each NASDAQ Exchange believes that it has set up mechanisms that protect the independence of the Exchange's regulatory responsibility with respect to NES, and has demonstrated that NES cannot use any information advantage it may have because of its affiliation with each NASDAQ Exchange.<sup>28</sup>

In the past, the Commission has expressed concern that the affiliation of an exchange with one of its members raises potential conflicts of interest and the potential for unfair competitive advantage.<sup>29</sup> Although the Commission continues to be concerned about potential

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<sup>27</sup> See Nasdaq Rule 2160(c); Phlx Rule 985(c)(2); BX Rule 2140(c). The NASDAQ Exchange rules each state that "NASDAQ OMX Group, Inc." shall establish and maintain these procedures and controls. Nasdaq, Inc. was formerly known as NASDAQ OMX Group, Inc. See Securities Exchange Act Release No. 75421 (July 10, 2015), 80 FR 42136 (July 16, 2015) (SR-BSECC-2015-001; SR-BX-2015-030; SR-NASDAQ-2015-058; SR-Phlx-2015-46; SR-SCCP-2015-01).

<sup>28</sup> See Nasdaq Notice, supra note 5, at 96088; Phlx Notice, supra note 5, at 96061-62; BX Notice, supra note 5, at 96101.

<sup>29</sup> See, e.g., Securities Exchange Act Release Nos. 54170 (July 18, 2006), 71 FR 42149 (July 25, 2006) (SR-NASDAQ-2006-006) (order approving Nasdaq's proposal to adopt Nasdaq Rule 2140, restricting affiliations between Nasdaq and its members); 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (SR-NYSE-2005-77) (order approving the combination of the New York Stock Exchange, Inc. and Archipelago Holdings, Inc.); 58673 (September 29, 2008), 73 FR 57707 (October 3, 2008) (SR-Amex-2008-62 and SR-NYSE-2008-60) (order approving the combination of NYSE Euronext and the American Stock Exchange LLC); 59135 (December 22, 2008), 73 FR 79954 (December 30, 2008) (SR-ISE-2008-85) (order approving the purchase by ISE Holdings of an ownership interest in Direct Edge Holdings LLC); 59281 (January 22, 2009), 74 FR 5014 (January 28, 2009) (SR-NYSE-2008-120) (order approving a joint venture between NYSE and BIDS Holdings L.P.); 58375 (August 18, 2008), 73 FR

unfair competition and conflicts of interest between an exchange's self-regulatory obligations and its commercial interest when the exchange is affiliated with one of its members, for the reasons discussed below, the Commission believes that it is consistent with the Act to permit NES, in its capacity as a facility of each of the ISE Exchanges, to route options orders inbound to each of the NASDAQ Exchanges, subject to the limitations and conditions described above.<sup>30</sup>

The Commission believes that these limitations and conditions will mitigate its concerns about potential conflicts of interest and unfair competitive advantage. In particular, the Commission believes that a non-affiliated SRO's oversight of NES,<sup>31</sup> combined with a non-affiliated SRO's monitoring of NES's compliance with each of the NASDAQ Exchange's rules and quarterly reporting to each NASDAQ Exchange, will help to protect the independence of Nasdaq's, BX's, and Phlx's regulatory responsibilities with respect to NES. The Commission also believes that the Exchanges' rules are designed to ensure that NES cannot use any information advantage it may have because of its affiliation with Nasdaq, BX, or Phlx, respectively.<sup>32</sup>

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49498 (August 21, 2008) (File No. 10-182) (order granting the exchange registration of BATS Exchange, Inc.); 61698 (March 12, 2010), 75 FR 13151 (March 18, 2010) (File Nos. 10-194 and 10-196) (order granting the exchange registration of EDGX Exchange, Inc. and EDGA Exchange, Inc.); and 62716 (August 13, 2010), 75 FR 51295 (August 19, 2010) (File No. 10-198) (order granting the exchange registration of BATS-Y Exchange, Inc.).

<sup>30</sup> The Commission notes that these limitations and conditions are consistent with those previously approved by the Commission for other exchanges. See, e.g., Securities Exchange Act Release Nos. 67256 (June 26, 2012), 77 FR 39277 (July 2, 2012) (SR-BX-2012-030) (order approving rules relating to the establishment of the BX options market) at 39281-39282; 69233, supra note 12; 69232, supra note 14; 69229, supra note 14; and the ISE Exchange Routing Orders, supra note 4.

<sup>31</sup> This oversight will be accomplished through the 17d-2 Agreement and the RSA.

<sup>32</sup> See supra note 27 and accompanying text.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>33</sup> that the proposed rule changes (SR-BX-2016-068; SR-NASDAQ-2016-169; SR-Phlx-2016-120), each as modified by their respective Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>34</sup>

Eduardo A. Aleman  
Assistant Secretary

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<sup>33</sup> 15 U.S.C. 78s(b)(2).

<sup>34</sup> 17 CFR 200.30-3(a)(12).