

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-71812; File No. SR-EDGX-2014-008)

March 26, 2014

Self-Regulatory Organizations; EDGX Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Amend Rule 12.6 to Conform to FINRA Rule 5320, BATS Rule 12.6 and BATS-Y Rule 12.6 Relating to Trading Ahead of Customer Orders

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on March 21, 2014, EDGX Exchange, Inc. (the “Exchange” or “EDGX”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I and II below, which items have been prepared by the self-regulatory organization. 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 is filing with the Commission a proposal to amend Rule 12.6, Customer Priority, to make it substantially similar to Financial Industry Regulatory Authority, Inc. (“FINRA”) Rule 5320, BATS Exchange, Inc. (“BATS”) Rule 12.6 and BATS-Y Exchange, Inc. (“BYX”) Rule 12.6. The text of the proposed rule change is available on the Exchange’s Internet website at [www.directedge.com](http://www.directedge.com), at the Exchange’s principal office, and at the Public Reference Room of the Commission.

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 self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments

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

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

it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization 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 the Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to amend Rule 12.6, which limits trading ahead of customer orders by Members,<sup>3</sup> to make the rule substantially similar to FINRA Rule 5320,<sup>4</sup> BATS Rule 12.6 and BYX Rule 12.6.<sup>5</sup>

On January 31, 2014, Direct Edge Holdings LLC (“DE Holdings”), the former parent company of the Exchange, completed its business combination with BATS Global Markets, Inc., the parent company of BATS and BYX.<sup>6</sup> As part of its effort to reduce regulatory duplication and relieve firms that are members of the Exchange, BATS, and BYX of conflicting or

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<sup>3</sup> The term “Member” is defined as “any registered broker or dealer, or any person associated with a registered broker or dealer, that has been admitted to membership in the Exchange. A Member will have the status of a “member” of the Exchange as that term is defined in Section 3(a)(3) of the Act.” See Exchange Rule 1.5(n).

<sup>4</sup> See Securities Exchange Act Release No. 63895 (February 11, 2011), 76 FR 9386 (February 17, 2011) (SR-FINRA-2009-090).

<sup>5</sup> See Securities Exchange Act Release No. 70952 (November 27, 2013), 78 FR 72949 (December 4, 2013) (SR-BATS-2013-056) (order approving proposal to amend BATS Rule 12.6); see also Securities Exchange Act Release No. 70951 (November 27, 2013), 78 FR 72944 (December 4, 2013) (SR-BYX-2013-036) (order approving proposal to amend Rule 12.6).

<sup>6</sup> See Securities Exchange Act Release No. 71449 (January 30, 2014), 79 FR 6961 (February 5, 2014) (SR-EDGX-2013-43). Upon completion of the Combination, DE Holdings and BATS Global Markets, Inc. each became intermediate holding companies, held under a single new holding company. The new holding company, formerly named “BATS Global Markets Holdings, Inc.,” changed its name to “BATS Global Markets, Inc.”

unnecessary regulatory burdens, the Exchange is now engaged in the process of reviewing and amending certain Exchange, BATS, and BYX Rules.

In addition, pursuant to Rule 17d-2 under the Act,<sup>7</sup> the Exchange and FINRA entered into an agreement to allocate regulatory responsibility for common rules (the “17d-2 Agreement”). The 17d-2 Agreement covers common members of the Exchange and FINRA and allocates to FINRA regulatory responsibility, with respect to common members, for the following: (i) examination of common members of the Exchange and FINRA for compliance with federal securities laws, rules and regulations and rules of the Exchange that the Exchange has certified as identical or substantially similar to FINRA rules; (ii) investigation of common members of EDGX and FINRA for violations of federal securities laws, rules or regulations, or Exchange rules that the Exchange has certified as identical or substantially identical to a FINRA rule; and (iii) enforcement of compliance by common members with the federal securities laws, rules and regulations, and the rules of the Exchange that the Exchange has certified as identical or substantially similar to FINRA rules.<sup>8</sup> The 17d-2 Agreement included a certification by the Exchange that states that the requirements contained in certain Exchange rules are identical to, or substantially similar to, certain FINRA rules that have been identified as comparable.

To conform to comparable FINRA rules for purposes of the 17d-2 Agreement, as well as BATS and BYX rules for purposes of its harmonization efforts due to its business combination, the Exchange proposes to amend Rule 12.6, Customer Priority, to align with FINRA Rule 5320, BATS Rule 12.6, and BYX Rule 12.6.

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<sup>7</sup> 17 CFR 240.17d-2.

<sup>8</sup> See Securities Exchange Act Release No. 61698 (March 12, 2010), 75 FR 13151 (March 18, 2010) (approving File No. 10-196).

As with FINRA Rule 5320, BATS Rule 12.6 and BYX Rule 12.6, amended Rule 12.6 would prohibit Members from trading ahead of customer orders, subject to specified exceptions. The amended rule would include exceptions for large orders and institutional accounts, proprietary transactions effected by a trading unit of a Member with no knowledge of customer orders held by another trading unit of the Member, riskless principal transactions, intermarket sweep orders (“ISOs”), and odd lot and bona fide error transactions, discussed in detail below. Amended Rule 12.6 would also provide the same guidance as FINRA Rule 5320, BATS Rule 12.6 and BYX Rule 12.6, on minimum price improvement standards, order handling procedures, and trading outside normal market hours.

#### Background

Current Rule 12.6, the customer order protection rule, generally prohibits Members from trading on a proprietary basis ahead of, or along with, customer orders that are executable at the same price as the proprietary order. The rule contains several exceptions that make it permissible for a Member to enter a proprietary order while representing a customer order that could be executed at the same price, including permitting transactions for the purposes of facilitating the execution, on a riskless principal basis, of one or more customer orders.

#### Proposal to Adopt Text of FINRA Rule 5320, BATS Rule 12.6 and BYX Rule 12.6

To harmonize its rules with FINRA, BATS, and BYX, the Exchange proposes to delete the current text of Rule 12.6 and its supplementary material and adopt the text and supplementary material of FINRA Rule 5320, with certain technical changes, as Rule 12.6. The proposed text of proposed Rule 12.6 would be identical to the text of BATS Rule 12.6 and BYX Rule 12.6. FINRA Rule 5320, BATS Rule 12.6, and BYX Rule 12.6 generally provide that a member that accepts and holds an order in an equity security from its own customer, or a

customer of another broker-dealer, without immediately executing the order is prohibited from trading that security on the same side of the market for its own account at a price that would satisfy the customer order, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account.

### Exceptions

Amended Rule 12.6 would include exceptions to the prohibition against trading ahead of customer orders. That is, a Member that meets the conditions of an exception would be permitted to trade a security on the same side of the market for its own account at a price that would satisfy a customer order in certain circumstances. The exceptions are set out below.

### Large Orders and Institutional Accounts

One exception would permit a Member to negotiate terms and conditions with respect to the acceptance of certain large-sized orders (orders of 10,000 shares or more unless such orders are less than \$100,000 in value) or orders from institutional accounts. The term “institutional account” will be defined in accordance with FINRA Rule 4512(c) and Interpretation and Policy .01 under both BATS and BYX Rules 12.6. That is, an institutional account will be defined as the account of: (1) a bank, savings and loan association, insurance company or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million. This exception would require the Member to provide clear and comprehensive written disclosure to each customer at account opening and annually thereafter that: (a) states that the Member may trade proprietarily at prices that would satisfy the customer order, and (b) provides the customer with a meaningful

opportunity to opt in to the Rule 12.6 protections with respect to all or any portion of its order. If a customer does not opt in to the protections with respect to all or any portion of its order, the Member may reasonably conclude that such customer has consented to the Member trading a security on the same side of the market for its own account at a price that would satisfy the customer's order.<sup>9</sup>

In lieu of providing written disclosure to customers at account opening and annually thereafter, the proposed rule would permit Members to provide clear and comprehensive oral disclosure to, and obtain consent from, a customer on an order-by-order basis. The Member would be required to document who provided such consent and that such consent evidences the customer's understanding of the terms and conditions of the order. If a customer opted in to the Rule 12.6 protections, a Member could still obtain consent on an order-by-order basis to trade ahead of or along with an order from that customer, provided that the Member documented who provided such consent and that such consent evidenced the customer's understanding of the terms and conditions of the order.

#### No-Knowledge Exception

The Exchange is also proposing to include in Interpretation and Policy .02 a "no-knowledge" exception to its customer order protection rule. The proposed exception would allow one trading unit of a Member to trade in a proprietary capacity and at prices that would satisfy customer orders held by another, separate trading unit of the Member. The No-Knowledge Exception would be applicable with respect to NMS stocks, as defined in Rule 600 of Regulation NMS under the Act.

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<sup>9</sup> A customer would retain the right to withdraw consent at any time. Therefore, a Member's reasonable conclusion that a customer has consented to the Member trading along with such customer's order is subject to further instruction and modification from the customer.

To avail itself of the No-Knowledge Exception, a Member would be required to meet certain conditions. First, it would have to implement and utilize an effective system of internal controls (such as appropriate information barriers) that operate to prevent the proprietary trading unit from obtaining knowledge of the customer orders held by a separate trading unit. As proposed, Interpretation and Policy .02 will make clear that appropriate information barriers must, at a minimum, comply with the Exchange's existing requirements regarding the prevention of the misuse of material, non-public information, which are set forth in Exchange Rule 5.5. Second, the Member would have to provide, at account opening and annually thereafter, a written description of how it handles customer orders and the circumstances under which it may trade proprietarily, including in a market-making capacity, at prices that would satisfy the customer order. A Member must maintain records indicating which orders rely on the no-knowledge exception and produce these records to the Exchange upon request. The onus will be on the Member to produce sufficient documentation justifying reliance on the No-Knowledge exception for any given trade. To ensure clarity and transparency regarding this exception and others, the Exchange will be issuing a regulatory notice informing Members of these proposed rule changes. The Exchange will include in the regulatory notice the effective date for the rule as amended, which shall be at least 30 days after the effectiveness of the amendments to Rule 12.6 in order to allow Members to make any necessary changes to their internal policies or processes.

#### Riskless Principal Exception

Amended Rule 12.6 would not apply to a proprietary trade made by the Member to facilitate the execution, on a riskless principal basis, of another order from a customer (whether its own customer or the customer of another broker-dealer). To take advantage of this exception, the Member would have to: (a) submit a report, contemporaneously with the execution of the

facilitated order, identifying the trade as riskless principal to the Exchange, and (b) have written policies and procedures to ensure that riskless principal transactions relied upon for this exception comply with applicable Exchange rules. At a minimum, these policies and procedures would have to require: (1) receipt of the customer order before execution of the offsetting principal transaction, and (2) execution of the offsetting principal transaction at the same price as the customer order, exclusive of any markup or markdown, commission equivalent, or other fee and allocation to a riskless principal or customer account in a consistent manner and within 60 seconds of execution.

Members would have to have supervisory systems in place that produce records that enable the Member and the Exchange to reconstruct accurately, readily, and in a time-sequenced manner all orders on which the Member relies in claiming this exception.

#### ISO Exception

The proposed rule change would also exempt a Member from the obligation to execute a customer order in a manner consistent with Rule 12.6 with regard to trading for its own account when the Member routed an ISO in compliance with Rule 600(b)(30)(ii) of Regulation NMS if the customer order is received after the Member routed the ISO. If a Member routes an ISO to facilitate a customer order, and that customer has consented to not receiving the better prices obtained by the ISO, the Member would also be exempt with respect to any trading for its own account that is the result of the ISO as it pertains to the consenting customer's order.

#### Odd Lot and Bona Fide Error Exception

The Exchange proposes to except a Member's proprietary trade that: (1) to offset a customer order that is an amount less than a normal unit of trading (i.e., an order less than one round lot, which is typically 100 shares), or (2) corrects a bona fide error. With respect to bona



bona fide errors, the Member would be required to demonstrate and document the basis upon which a transaction meets the bona fide error exception. For purposes of this proposed Rule, the Exchange will adopt the definition of “bona fide error” found in Regulation NMS’s exemption for error correction transactions.<sup>10</sup> Thus, a bona fide error is:

(i) The inaccurate conveyance or execution of any term of an order including, but not limited to, price, number of shares or other unit of trading; identification of the security; identification of the account for which securities are purchased or sold; lost or otherwise misplaced order tickets; short sales that were instead sold long or vice versa; or the execution of an order on the wrong side of a market; (ii) the unauthorized or unintended purchase sale or allocation of securities or the failure to follow specific client instructions; (iii) the incorrect entry of data into relevant systems, including reliance on incorrect cash positions, withdrawals, or securities positions reflected in an account; or (iv) a delay, outage, or failure of a communication system used to transmit market data prices or to facilitate the delivery or execution of an order.<sup>11</sup>

#### Minimum Price Improvement Standards

The proposed rule change establishes the minimum amount of price improvement necessary for a Member to execute an order on a proprietary basis when holding an unexecuted limit order in that same security without being required to execute the held limit order.

In addition, if the minimum price improvement standards set forth in proposed Interpretation and Policy .06, paragraphs (a) through (g) would trigger the protection of a pending customer limit order, any better-priced customer limit order(s) must also be protected under this Rule, even if those better-priced limit orders would not be directly triggered under these minimum price improvement standards.

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<sup>10</sup> Securities Exchange Act Release No. 55884 (June 8, 2007), 72 FR 32926, 32927 (June 14, 2007) (Order Exempting Certain Error Correction Transactions from Rule 611 of Regulation NMS under the Securities Exchange Act of 1934).

<sup>11</sup> Id.

### Order Handling Procedures

The proposed rule change provides that a Member must make every effort to execute a marketable customer order that it receives fully and promptly. A Member holding a marketable customer order that has not been immediately executed would have to make every effort to cross such order with any other order received by the Member on the other side of the market, up to the size of such order at a price that is no less than the best bid and no greater than the best offer at the time that the subsequent order is received by the Member and that is consistent with the terms of the orders. If a Member were holding multiple orders on both sides of the market that have not been executed, the Member would have to make every effort to cross or otherwise execute such orders in a manner reasonable and consistent with the objectives of the proposed Rule and with the terms of the orders. A Member could satisfy the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price.

### Trading Outside Normal Market Hours

Under the proposed amendments to Rule 12.6, a Member generally could limit the life of a customer order to the period of normal market hours of 9:30 a.m. to 4:00 p.m. Eastern Time. However, if the customer and Member agreed to the processing of the customer's order outside normal market hours, the protections of amended Rule 12.6 would apply to that customer's order at all times the customer order is executable by the Member.

### Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act<sup>12</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act<sup>13</sup> in particular, in that it is designed to promote just and equitable principles of trade, to foster cooperation and coordination

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<sup>12</sup> 15 U.S.C. 78f(b).

<sup>13</sup> 15 U.S.C. 78f(b)(5).

with persons engaged in 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. The Exchange believes that amending the rule to conform to FINRA Rule 5320, BATS Rule 12.6 and BYX Rule 12.6 will contribute to investor protection by defining important parameters by which Members must abide when trading proprietarily while holding customer limit and market orders, and foster cooperation by harmonizing requirements across self-regulatory organizations. The Exchange also believes that including this rule will reinforce the importance of and ensure that Members are aware of these requirements.

Members who are also members of FINRA, BATS, or BYX are subject to different regulatory standards when seeking to comply with applicable rules regarding customer protection. The Exchange believes that the proposed rule change will provide greater harmonization between similar Exchange and FINRA, BATS, and BYX rules, resulting in greater uniformity and, less burdensome and more efficient regulatory compliance for common members. As such, the proposed rule change would foster cooperation and coordination with persons engaged in facilitating transactions in securities and would remove impediments to and perfect the mechanism of a free and open market and a national market system.

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. To the contrary, the Exchange believes that the proposal enhances cooperation among markets and other trading venues to promote fair and orderly markets and to protect the interests of the public and of investors. Specifically, by aligning the Exchange's customer protection rules with those of

FINRA, BATS, BYX and other exchanges,<sup>14</sup> the proposed rule change will reduce the complexity of the customer order protection rules for those Members that are also subject to the customer order protection rules of FINRA and other exchanges. As a result, the proposed rule will help assure the protection of customer orders without imposing undue regulatory costs on industry participants. In addition, the proposed rule change is not designed to address any competitive issues but rather is designed to provide greater harmonization among similar Exchange and FINRA rules, resulting in less burdensome and more efficient regulatory compliance for common members and facilitating FINRA's performance of its regulatory functions under the 17d-2 Agreement.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The Exchange has neither solicited nor received written comments on the proposed rule change.

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

The Exchange has filed the proposed rule change pursuant to Section 19(b)(3)(A) of the Act<sup>15</sup> and Rule 19b-4(f)(6) thereunder.<sup>16</sup> Because the proposed rule change does not: (i)

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<sup>14</sup> See, e.g., Securities Exchange Act Release No. 64418 (May 6, 2011), 76 FR 27735 (May 12, 2011) (SR-CHX-2011-08) (notice of filing and immediate effectiveness of proposed rule change of Chicago Stock Exchange, Inc. to adopt customer order protection language consistent with FINRA Rule 5320); Securities Exchange Act Release No. 65165 (August 18, 2011), 76 FR 53009 (August 24, 2011) (SR-NYSEAmex-2011-59) (notice of filing and immediate effectiveness of proposed rule change of NYSE Amex LLC (now known as NYSE MKT LLC) to adopt customer order protection language that is substantially the same as FINRA Rule 5320); and Securities Exchange Act Release No. 65166 (August 18, 2011), 76 FR 53012 (August 24, 2011) (SR-NYSEArca-2011-57) (notice of filing and immediate effectiveness of proposed rule change of NYSE Arca, Inc. to adopt customer order protection language that is substantially the same as FINRA Rule 5320).

<sup>15</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>16</sup> 17 CFR 240.19b-4(f)(6).

significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative prior to 30 days from the date on which it was filed, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest, the proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Act<sup>17</sup> and Rule 19b-4(f)(6) thereunder.<sup>18</sup>

At any time within 60 days of the filing of such proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### 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 e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-EDGX-2014-008 on the subject line.

##### Paper comments:

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

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<sup>17</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>18</sup> 17 CFR 240.19b-4(f)(6). In addition, Rule 19b-4(f)(6) requires the Exchange to give the Commission written notice of the Exchange's intent to file the proposed rule change, along with a brief description and text of 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.

All submissions should refer to File Number SR-EDGX-2014-008. This file number should be included on the subject line if e-mail 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 website (<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 website 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-EDGX-2014-008 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>19</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>19</sup> 17 CFR 200.30-3(a)(12).