

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-87200; File No. SR-CboeEDGX-2019-012)

October 2, 2019

Self-Regulatory Organizations; Cboe EDGX Exchange, Inc.; Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Introduce Retail Priority

I. Introduction

On March 18, 2019, Cboe EDGX Exchange, Inc. (“Exchange” or “EDGX”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to introduce order book priority for equity orders submitted on behalf of retail investors. The proposed rule change was published for comment in the Federal Register on April 5, 2019.³ The Commission received five comment letters from four commenters on the proposed rule change.⁴ On May 16, 2019, the Commission extended the time period within which to approve, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to July 4, 2019.⁵ On June 18, 2019, the Exchange filed Amendment No. 1 to the proposed rule change, which replaced and superseded the proposed rule

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 85482 (April 2, 2019), 84 FR 13729 (“Notice”).

⁴ See letters to Vanessa Countryman, Acting Secretary, Commission, from Sean Paylor, Trader, AJO, L.P., dated April 25, 2019 and September 16, 2019 (“AJO Letter 1” and “AJO Letter 2”, respectively); Joseph Saluzzi and Sal Arnuk, Partners, Themis Trading LLC, dated May 8, 2019 (“Themis Letter”); T. Sean Bennett, Principal Associate General Counsel, Nasdaq, dated May 9, 2019 (“Nasdaq Letter”); letter to Eduardo A. Aleman, Deputy Secretary, Commission from Stephen John Berger, Global Head of Government & Regulatory Policy, Citadel Securities, dated April 26, 2019 (“Citadel Letter”). All comments received by the Commission on the proposed rule change are available at: <https://www.sec.gov/comments/sr-cboeedgx-2019-012/srcboeedgx2019012.htm>.

⁵ See Securities Exchange Act Release No. 85879, 84 FR 23591 (May 16, 2019).

change as originally filed.⁶ On July 2, 2019, the Commission published Amendment No. 1 for notice and comment and instituted proceedings to under Section 19(b)(2)(B) of the Act⁷ to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.⁸ On August 19, 2019 the Exchange submitted a response to comments.⁹ This order approves the proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposed Rule Change, as Modified by Amendment No. 1

EDGX proposes to introduce order book priority for Retail Priority Orders. In addition, EDGX proposes to require that Retail Priority Orders always be designated as such on the EDGX Book Feed.¹⁰

A. Background

⁶ Amendment No. 1 modified the proposed rule change by: (1) adding a proposed definition of “Retail Priority Order”; (2) applying the proposed enhanced priority to “Retail Priority Orders” instead of “Retail Orders”; (3) imposing certain requirements on Retail Member Organizations that enter “Retail Priority Orders”; (4) removing the proposed requirement that “Retail Orders” must be identified as such on the EDGX Book Feed; and (5) requiring that all “Retail Priority Orders” be identified as such on the EDGX Book Feed. To promote transparency of its proposed amendment, when EDGX filed Amendment No. 1 with the Commission, it also submitted Amendment No. 1 as a comment letter to the file, which the Commission posted on its website and placed in the public comment file for SR-CboeEDGX-2019-012 (available at <https://www.sec.gov/comments/sr-cboeedgx-2019-012/srcboeedgx2019012.htm>).

⁷ 15 U.S.C. 78s(b)(s)(B).

⁸ See Securities Exchange Act Release No. 86280 (July 2, 2019), 84 FR 32808 (July 9, 2019)(“Notice of Amendment No. 1”). Specifically, the Commission instituted proceedings to allow for additional analysis of the proposed rule change’s consistency with Section 6(b)(5) of the Act, 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,” and “to protect investors and the public interest.” See id. at 32815 (citing 15 U.S.C. 78f(b)(5)).

⁹ See Letter to Vanessa Countryman, Secretary, Commission, from Adrian Griffiths, Assistant General Counsel, EDGX, dated August 19, 2019 (“EDGX Response Letter”).

¹⁰ See EDGX Rule 13.8.

EDGX operates based on price/display/time priority, similar to many other equities and options exchanges.¹¹ Under this framework, a better priced order maintains priority over an order at a worse price. At a particular price, the first Displayed¹² order resting on the EDGX Book¹³ at a particular price has priority over the next order and so on based on the time of order entry. Non-Displayed¹⁴ orders at that price are further categorized into a number of priority bands, with orders within each priority band prioritized again based on the time of order entry.

Under EDGX rules, a “Retail Order” is defined as an agency or riskless principal order that meets the criteria of FINRA Rule 5320.03¹⁵ that originates from a natural person and is submitted to the Exchange by a Retail Member Organization, provided that no change is made to the terms of the order with respect to price or side of market and the order does not originate from a trading algorithm or any other computerized methodology.¹⁶ A “Retail Member Organization” (“RMO”) is a Member (or a division thereof) that has been approved by the Exchange under EDGX Rule 11.21 to submit Retail Orders. EDGX Rule 11.21(b) describes the

¹¹ See EDGX Rule 11.9.

¹² “Displayed” is an instruction the User may attach to an order stating that the order is to be displayed by the System on the EDGX Book. See EDGX Rule 11.6(e)(1).

¹³ “EDGX Book” means the System’s electronic file of orders. See EDGX Rule 1.5(d)

¹⁴ “Non-Displayed” is an instruction the User may attach to an order stating that the order is not to be displayed by the System on the EDGX Book. See EDGX Rule 11.6(e)(2).

¹⁵ FINRA Rule 5320.03 clarifies that an Retail Member Organization may enter Retail Orders on a riskless principal basis, provided that (i) the entry of such riskless principal orders meet the requirements of FINRA Rule 5320.03, including that the Retail Member Organization maintains supervisory systems to reconstruct, in a time sequenced manner, all Retail Orders that are entered on a riskless principal basis; and (ii) the Retail Member Organization submits a report, contemporaneously with the execution of the facilitated order, that identifies the trade as riskless principal.

¹⁶ Retail Member Organizations will only be able to designate their orders as Retail Orders on either an order-by-order basis using FIX ports or by designating certain of their FIX ports at the Exchange as “Retail Order Ports.” Unless otherwise instructed by the Retail Member Organization, a Retail Order will be identified as Retail when routed to an away Trading Center. See EDGX Rule 11.21(d).

qualification and application process for becoming a Retail Member Organization; generally, any member may qualify as a Retail Member Organization if it conducts a retail business or routes retail orders on behalf of another broker-dealer.

B. Retail Order Priority

The Exchange proposes to amend EDGX Rule 11.9 to introduce order book priority benefits exclusively to Retail Orders that are entered on behalf of retail investors that enter a limited number of equity orders each trading day. Such orders are being defined by the Exchange as a “Retail Priority Order.”¹⁷ To qualify as a Retail Priority Order, the order must be a Retail Order, as defined in EDGX Rule 11.21(a)(2), that is entered on behalf of a person that does not place more than 390 equity orders per day on average during a calendar month for its own beneficial account(s).¹⁸ All orders entered on behalf of a retail customer would be counted to determine whether a customer’s Retail Orders could be identified as Retail Priority Orders. This would therefore include both orders routed to other exchanges and orders that are not entered as Retail Orders (e.g., because the price of such orders is modified by a broker-dealer algorithm).¹⁹

¹⁷ See proposed EDGX Rule 11.9, Interpretations and Policies .01.

¹⁸ Id. The Exchange states that 390 orders per day represents one order entered each minute during regular trading hours – i.e., from 9:30 a.m. ET to 4:00 p.m. ET. See supra note 8, Notice of Amendment No. 1 at 32809.

¹⁹ The Exchange also addresses how to count parent/child orders and cancel/replace orders when determining whether the 390 order per day threshold has been exceeded. As proposed, parent/child orders would be counted as a single order – i.e., a “parent” order that is broken into multiple “child” orders by a broker or dealer, or by an algorithm housed at a broker or dealer or by an algorithm licensed from a broker or dealer, but which is housed with the customer, would count as one order even if the “child” orders are routed across multiple exchanges. In addition, with one exception for parent/child orders, any order that cancels and replaces an existing order would count as a separate order. An order that cancels and replaces any “child” order resulting from a “parent” order that is broken into multiple “child” orders, would not count as a new order. See supra note 8 at 32809-10.

Pursuant to the proposal, RMOs that enter Retail Priority Orders would be required to have reasonable policies and procedures in place to ensure that such orders are appropriately represented on the Exchange.²⁰ Such policies and procedures should provide for a review of retail customers' activity on at least a quarterly basis.²¹ Retail Orders for any retail customer that had an average of more than 390 orders per day during any month of a calendar quarter would not be eligible to be entered as Retail Priority Orders for the next calendar quarter.²² RMOs would be required to conduct a quarterly review and make any appropriate changes to the way in which they are representing orders within five business days after the end of each calendar quarter.²³ While RMOs would only be required to review their accounts on a quarterly basis, if during a quarter the Exchange identifies a retail customer for which orders are being represented as Retail Priority Orders but that has averaged more than 390 orders per day during a month, the Exchange would notify the RMO, and the RMO would be required to change the manner in which it is representing the retail customer's orders within five business days.²⁴ The Exchange notes that the proposed provisions relating to the obligations of RMOs are similar to the obligations applicable to the Priority Customer designation in the options industry.²⁵

As described more fully in Amendment No. 1, that portion of a Retail Order with a Displayed instruction would be given allocation priority ahead of all other available interest on the EDGX Book.²⁶ This would be true of both orders executed pursuant to the regular priority

²⁰ See proposed EDGX Rule 11.9, Interpretations and Policies .02.

²¹ Id.

²² See proposed EDGX Rule 11.9, Interpretations and Policies .02(a).

²³ Id.

²⁴ See proposed EDGX Rule 11.9, Interpretations and Policies .02(b).

²⁵ See Notice of Amendment No. 1, supra note 8, at 32810.

²⁶ Id.

bands described in EDGX Rule 11.9(a)(2)(A), and orders priced at the midpoint of the NBBO pursuant to EDGX Rule 11.9(a)(2)(B) where Retail Priority Orders subject to Display-Price Sliding would have priority ahead of limit orders entered with such an instruction as well as any other orders resting at the midpoint of the NBBO. In addition, since Reserve Orders contain a Displayed instruction but include both Displayed and Non-Displayed shares, the Reserve Quantity of Retail Priority Orders would be given priority ahead of the Reserve Quantity of other limit orders on the EDGX Book. Retail Priority Orders that are not willing to be displayed, or are only willing to be displayed at a less aggressive price than the execution price, would not receive any special priority. This priority for Retail Orders would be in place during all trading sessions and would be available to orders entered for participation in the Exchange's opening process and the re-opening process following a halt.²⁷

C. Retail Order Attribution

Currently, RMOs that submit Retail Orders to the Exchange have the option of identifying Retail Orders as such on the EDGX Book Feed.²⁸ In the instant proposal, EDGX is requiring that Retail Priority Orders always be designated as such on the EDGX Book Feed.²⁹ Retail Orders that are not designated as Retail Priority Orders could continue to be attributed or not, at the discretion of the RMO.

III. Comment Summary

The Commission received five comment letters from four commenters on the proposed rule change.³⁰ All four commenters express concerns about the proposed rule change, as initially

²⁷ Id.

²⁸ See EDGX Rule 11.21(f).

²⁹ See proposed EDGX Rule 11.21(f).

³⁰ See supra note 4.

proposed. Following the publication of Amendment No. 1, the one of the four commenters submitted another comment letter that expresses continuing concerns about the proposed rule change, as amended.

Two commenters expressed concerns about the Exchange’s initial definition of “Retail Order,” both noting that the definition does not adequately distinguish retail investors’ orders from active professional traders’ orders, potentially resulting in the granting of queue priority to professional traders.³¹ One commenter stated that this would impair market quality, undermine the intended benefits for bona fide retail investors, adversely affect institutional investor fill rates, and impair the provision of displayed liquidity.³² This commenter also suggested that active professional orders could more easily implement spread capture models by simply trading back-and-forth at the top of the queue.³³ This commenter further suggested that the Exchange should amend the definition of “Retail Order” and noted that the options markets use a definition of “professional customer” to distinguish them from retail customers.³⁴ The other commenter expressed concern that the Exchange has not addressed issues with enforcing the Retail Order definition, by, among other things, failing to adequately consider investor protection issues raised by the proposed rule change.³⁵ This commenter stated that the Exchange does not provide any detail on how it would protect investors from the misuse of retail priority and believes that the Exchange must provide more detail on how it will protect investors.³⁶

³¹ See Citadel Letter, supra note 4, at 1-2; Nasdaq Letter, supra note 4, at 1.

³² See Citadel Letter, supra note 4, at 1-2.

³³ See Citadel Letter, supra note 4, at 2.

³⁴ See Citadel Letter, supra note 4, at 2.

³⁵ See Nasdaq Letter, supra note 4, at 1.

³⁶ See Nasdaq Letter, supra note 4, at 2.

One commenter stated that the initial rule proposal is “the quintessential example of customer discrimination.”³⁷ This commenter noted that the initial rule proposal is purportedly designed with ordinary investors in mind, but the Retail Order designation can only be utilized by a minority of ordinary investors, noting that pension funds and institutional managers trading on behalf of “ordinary investors” would not receive the benefit of order priority.³⁸ This commenter maintained that the proposed order type discriminates against a significant portion of ordinary investors as initially proposed and even as amended.³⁹

Three commenters expressed concerns relating to the requirement, as set forth in the initial proposal, that Retail Orders will be designated as such on the EDGX Book Feed.⁴⁰ Two of these commenters stated that only those market participants who purchase the appropriate EDGX proprietary data feeds will have access to this information, and identifying Retail Orders will allow these market participants to identify institutional orders.⁴¹ One commenter suggested that this places these market participants at an “informational advantage over others.”⁴² Another commenter stated that such order information leakage will result in increased adverse selection for institutional investors and also believes that the unique data will make the relevant EDGX data feed more valuable and likely encourages consumers of those data feeds to continue purchasing these data feeds.⁴³ One commenter noted that institutional investors have no ability

³⁷ See AJO Letter 1, supra note 4, at 2-3.

³⁸ See AJO Letter 1, supra note 4, at 1; see also AJO Letter 2, supra note 4, at 2.

³⁹ See AJO Letter 1, supra note 4, at 4; see also AJO Letter 2, supra note 4, at 2, 4.

⁴⁰ See Nasdaq Letter, supra note 4, at 2-3; AJO Letter 1, supra note 4 at 2; Themis Letter, supra note 4 at 2.

⁴¹ See AJO Letter 1, supra note 4, at 2; Themis Letter, supra note 4, at 1-2.

⁴² See AJO Letter 1, supra note 4, at 2.

⁴³ See Themis Letter, supra note 4, at 2.

to opt out, unlike Retail Member Organizations that could choose to submit orders that would qualify as Retail Orders if so designated, but are submitted without applying such designation.⁴⁴

In its response letter, EDGX states that the proposal, as modified by Amendment No. 1, limits retail priority to only a subset of Retail Orders (i.e., Retail Priority Orders) and therefore renders the information leakage question “moot” because the RMO would retain the choice of whether or not to attribute the order.⁴⁵ EDGX also notes that because only a subset of Retail Orders would be required to be attributed on the EDGX Book Feed, market participants would not be able to infer that any non-attributable order is an institutional order.⁴⁶

EDGX responds to the concern raised by a commenter regarding the possible abuse of retail order priority by noting that the Exchange has limited retail priority to orders entered on behalf of investors that enter only a limited number of equity order each trading day, and asserting that the Exchange has an effective regulatory program to address member compliance with the retail priority order requirements.⁴⁷ EDGX also states that its Regulatory Division intends to implement enhancements to its current regulatory program designed to oversee RMO compliance with the retail priority rules to ensure that orders entered with a priority attribute are appropriately marked.⁴⁸

IV. Discussion and Commission Findings

⁴⁴ See AJO Letter 1, supra note 4, at 3.

⁴⁵ See EDGX Response Letter, supra note 9 at 2. One commenter maintained that there is still “information leakage” which will permit institutional orders to be identified after the Exchange amended the original proposal to remove the requirement that all retail orders be attributed. See AJO Letter 2, supra note 4, at 2.

⁴⁶ Id.

⁴⁷ See EDGX Response Letter, supra note 9 at 3.

⁴⁸ Id.

After careful review, the Commission finds that the proposed rule change, as modified by Amendment No.1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.⁴⁹ In particular, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with Section 6(b)(5) of the Act,⁵⁰ which requires, among other things, that the Exchange's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, 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, and that the rules are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The Commission believes that the Exchange's proposal represents a reasonable effort to enhance the ability of bona fide retail trading interest to compete for executions with orders entered by other market participants that may be better equipped to optimize their place in the intermarket queue.⁵¹ Under the proposal, bona fide retail orders will be in a position to compete

⁴⁹ In approving this proposed rule change the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

⁵⁰ 15 U.S.C. 78f(b)(5).

⁵¹ Under existing EDGX Rules, to qualify as a RMO, Members must submit to the Exchange, among other things, an attestation that substantially all orders submitted as Retail Orders will qualify as such, and must have written policies and procedures that are reasonably designed to ensure that the Member will only designate orders as Retail Order if all the requirements of a Retail Order are met. In addition, if the Member represents Retail Orders from another broker-dealer customer, that Member's supervisory procedures must be reasonably designed to assure that the orders it receives from such broker dealer customer that it designates as Retail Orders meet the definition of a Retail Order. Such Members also must (i) obtain an annual written representation from each broker-dealer customer that sends it orders to be designated as Retail Orders that entry of such orders as Retail Orders will be in compliance with the requirements specified by the Exchange, and (ii) monitor whether its broker-dealer customer's Retail Order flow continues to meet the applicable requirements. See generally EDGX Rule 11.21(b).

for executions as long as they are qualified as such and attributed as such, which should lead to increased or more immediate execution opportunities on the Exchange for resting Retail Priority Orders. Furthermore, in order to qualify as a Retail Priority Order, the Exchange is requiring RMOs that enter Retail Priority Orders to have reasonable policies and procedures in place to ensure that such order are appropriately represented on the Exchange.⁵² RMOs also must conduct a quarterly review of retail customers' activity and make any appropriate changes to the way in which the RMO is representing orders within five business days after the end of each calendar quarter. In addition, if the Exchange identifies a retail customer whose orders are being represented by an RMO that exceed 390 order per day during a month, the Exchange will notify the RMO and the RMO will be required to change the manner in which it is representing the retail customer's orders within five business days. The Commission also notes that the Exchange's Regulatory Division intends to implement enhancements to its current regulatory program designed to oversee RMO compliance with the retail priority rules to ensure that orders entered with a priority attribute are appropriate marked.⁵³

For the foregoing reasons, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with Section 6(b)(5) of the Act⁵⁴ and the rules and regulations thereunder applicable to a national securities exchange.

⁵² See proposed EDGX Rule 11.9, Interpretations and Policies .02.

⁵³ Id.

⁵⁴ 15 U.S.C. 78f(b)(5).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁵⁵ that the proposed rule change, as modified by Amendment No. 1 (SR-CboeEDGX-2019-012) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁵⁶

Jill M. Peterson
Assistant Secretary

⁵⁵ 15 U.S.C. 78s(b)(2).

⁵⁶ 17 CFR 200.30-3(a)(12).