

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67010; File No. SR-EDGX-2012-08)

May 17, 2012

Self-Regulatory Organizations; EDGX Exchange, Inc.; Order Approving a Proposed Rule Change Relating to Amendments to Rule 2.11 that Establish the Authority to Cancel Orders and Describe the Operation of an Error Account

I. Introduction

On March 22, 2012, 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 amend EDGX Rule 2.11 to (1) add a new subparagraph (a)(6) that addresses the authority of EDGX and its routing broker-dealer, Direct Edge ECN LLC d/b/a/ DE Route (“DE Route”) to cancel orders if and when a systems, technical, or operational issue occurs, and (2) amend subparagraph (a)(4) and add new subparagraph (a)(7) to describe the operation of an error account for DE Route. The proposed rule change was published for comment in the Federal Register on April 6, 2012.³ The Commission received no comment letters regarding the proposed rule change. This order approves the proposed rule change.

II. Description of the Proposal

DE Route, a broker-dealer that is a facility and an affiliate of the Exchange, provides outbound routing services from the Exchange to other market centers pursuant to Exchange

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 66713 (April 2, 2012), 77 FR 20854 (April 6, 2012) (SR-EDGX-2012-08) (“Notice”).

rules.⁴ In its proposal, the Exchange states that a systems, technical, or operational issue may occur at EDGX, DE Route, or a Trading Center⁵ that causes EDGX or DE Route to cancel orders, if the Exchange or DE Route determines that such action is necessary to maintain a fair and orderly market.⁶ The Exchange also states that systems, technical, or operational issues that occur at EDGX, DE Route, or a Trading Center may result in DE Route acquiring an error position that it must resolve.⁷

New subparagraph (a)(6) to EDGX Rule 2.11 provides EDGX or DE Route with general authority to cancel orders to maintain fair and orderly markets when a systems, technical, or operational issue occurs at EDGX, DE Route, or a Trading Center. EDGX or DE Route will be required to provide notice of the cancellation of orders to Members⁸ as soon as practicable.⁹

⁴ See Notice, 77 FR at 20855, n.4 and accompanying text, and text accompanying n.6. See also EDGX Rule 2.11; and Securities Exchange Act Release No. 61698 (March 12, 2010) 75 FR 13151 (March 18, 2010) at 13165.

The Exchange also receives equities orders routed inbound to the Exchange by DE Route from EDGA Exchange, Inc. under a pilot period ending on June 30, 2013. See Notice, 77 FR at 20855. See also Securities Exchange Act Release No. 64361 (April 28, 2011), 76 FR 25388 (May 4, 2011) (SR-EDGX-2011-12); and Securities Exchange Act Release No. 66644 (March 22, 2012), 77 FR 18877 (March 28, 2012) (SR-EDGX-2012-09) (filing to extend the pilot period through June 30, 2013).

⁵ EDGX Rule 2.11(a) defines “Trading Center” as “other securities exchanges, facilities of securities exchanges, automated trading systems, electronic communications networks or other brokers or dealers.” See also Notice, 77 FR at 20855, n.5 (stating that “Trading Centers” is as defined in EDGX Rule 2.11(a) and Rule 600(b)(78) of Regulation NMS under the Act, 17 CFR 242.600(b)(78)).

⁶ See Notice, 77 FR at 20855. For examples of some of the circumstances in which EDGX or DE Route may decide to cancel orders, see id.

⁷ See id. For examples of some of the circumstances that may lead to error positions, see id.

⁸ EDGX Rule 1.5(n) defines “Member” to mean “any registered broker or dealer, or any person associated with a registered broker or dealer, that has been admitted to membership in the Exchange” and states that “[a] Member will have the status of a

New subparagraphs (a)(4) and (a)(7) provide authority for DE Route to maintain an error account for the purpose of addressing, and sets forth the procedures for resolving, error positions. Specifically, DE Route will maintain an error account for the purpose of liquidating an error position acquired in connection with its role as an Outbound Router¹⁰ when such position, in the judgment of DE Route subject to the factors described in EDGX Rule 2.11(a)(7) (and as set forth below), cannot be fairly and practicably assigned to one or more Members in its entirety.¹¹

In determining whether an entire error position can be fairly and practicably assigned to one or more Members, DE Route will consider (i) whether DE Route has accurate and sufficient information to assign the entire amount of an error position to all affected Members; and (ii) whether DE Route is able to evaluate available information in order to assign the entire amount of an error position to all affected Members by the first business day following the trade date on which the error position was established.¹² If DE Route determines that an error position can be assigned to one or more Members by the first business day following the trade date on which the error position was incurred, DE Route will (i) assign the entire amount of the error position to all affected Members, and (ii) make and keep records to document the rationale for the assignment

‘member’ of the Exchange as that term is defined in Section 3(a)(3) of the [Exchange] Act.”

⁹ See EDGX Rule 2.11(a)(6).

¹⁰ EDGX Rule 2.11(a) defines DE Route, in its function providing outbound routing of orders from the Exchange to other Trading Centers, as the “Outbound Router.”

¹¹ See EDGX Rule 2.11(a)(7). An error position can be acquired as a result of a systems, technical, or operational issue experienced by EDGX, DE Route, or a Trading Center to which DE Route directed an outbound order. See id.

¹² See id.

to those Members.¹³ All determinations and assignments will be made in a non-discriminatory manner.¹⁴

If, however, DE Route reasonably concludes, due to the number of erroneous executions or the number of members potentially impacted, that it would not be able to trace each erroneous execution comprising an error position back to the affected Members in a timely manner, then DE Route will assume the entire amount of the error position into the error account.¹⁵ DE Route will make and keep records of the factors considered in determining whether to acquire an error position into the error account.¹⁶

If DE Route determines to acquire an error position into the error account, DE Route will liquidate the error position as soon as practicable.¹⁷ DE Route will be required to provide complete time and price discretion for the trading to liquidate the error positions to a third-party broker-dealer, and would be prohibited from attempting to exercise any influence or control over the timing or methods of such trading.¹⁸ Further, DE Route will be required to establish and implement written policies and procedures that are reasonably designed to restrict the flow of confidential and proprietary information between the third-party broker-dealer, on one hand, and the Exchange and DE Route, on the other, associated with the liquidation of the error positions.¹⁹

¹³ See id.

¹⁴ See id.

¹⁵ See Notice, 77 FR at 20856.

¹⁶ See EDGX Rule 2.11(a)(7).

¹⁷ See id.

¹⁸ See id.

¹⁹ See id.

DE Route will make and keep records associated with the liquidation of the error position through a third-party broker-dealer.²⁰

III. Discussion and Commission's Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of Section 6(b) of the Act²¹ and the rules and regulations thereunder applicable to a national securities exchange.²² In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,²³ 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, 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; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. In addition, the Commission believes the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act²⁴ in that it seeks to assure economically efficient execution of securities transactions.

The Commission recognizes that a systems, technical, or operational issue may occur, and believes that EDGX Rule 2.11, in allowing EDGX or DE Route to cancel orders affected by

²⁰ See id.

²¹ 15 U.S.C. 78f(b).

²² 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).

²³ 15 U.S.C. 78f(b)(5).

²⁴ 15 U.S.C. 78k-1(a)(1)(C).

a systems, technical, or operational issue, should provide a reasonably efficient means for the Exchange to handle such orders, and appears reasonably designed to permit EDGX to maintain fair and orderly markets.²⁵

The Commission also believes that allowing DE Route to maintain an error account to resolve error positions acquired in connection with its role as an Outbound Router pursuant to the procedures set forth in the rule, and as described above, is consistent with the Act. The Commission notes that the rule establishes criteria for determining which positions are error positions that may be acquired into the error account, and which will be assigned to Members.²⁶ DE Route, in connection with a particular systems, technical, or operational issue, will be required to either (i) assign the entire amount of a resulting error position to Members or (ii) liquidate such position.²⁷ Also, DE Route will assign an error position that results from a particular systems, technical, or operational issue to Members only if the entire amount of such error position can be assigned to all of the affected Members.²⁸ If DE Route cannot fairly and practically assign the entire amount of an error position to all affected Members, DE Route will liquidate such error position.²⁹ In this regard, the Commission believes that the new rule appears

²⁵ The Commission notes that EDGX states that the proposed amendments to EDGX Rule 2.11 are designed to maintain fair and orderly markets, ensure full trade certainty for market participants, and avoid disrupting the clearance and settlement process. See Notice, 77 FR at 20857. The Commission also notes that EDGX states that a decision to cancel orders due to a systems, technical, or operational issue may not cause the Exchange to declare self-help against a Trading Center pursuant to Rule 611 of Regulation NMS, in which case the Exchange would continue to be subject to the order protection requirements of Rule 611 with respect to that Trading Center. See 17 CFR 242.611(b). See also Notice, 77 FR at 20856, n.12.

²⁶ See EDGX Rule 2.11(a)(7).

²⁷ See id.

²⁸ See id.

²⁹ See id.

reasonably designed to further just and equitable principles of trade and the protection of investors and the public interest, and to help prevent unfair discrimination, in that it should help assure the handling of error positions will be based on clear and objective criteria, and that the resolution of those positions will occur promptly through a transparent process.

Additionally, the Commission notes that it has previously expressed concern about the potential for 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.³⁰ The Commission is also concerned about the potential for misuse of confidential and proprietary information. The Commission believes that the requirement that DE Route provide complete time and price discretion for the liquidation of an error position to a third-party broker-dealer, including that DE Route not attempt to exercise any influence or control over the timing or methods of such trading, combined with the requirement that DE Route establish and implement policies and procedures that are reasonably designed to restrict the flow of confidential and proprietary information to the third-party routing broker liquidating such positions, should help mitigate the Commission's concerns. In particular, the Commission believes that these requirements should help assure that none of EDGX, DE Route, or the third-party broker-dealer is able to misuse confidential or proprietary information obtained in connection with the liquidation of error positions for its own benefit. The Commission also notes that DE Route would be required to make and keep records documenting the rationale for assignment of error positions to Members, documenting the factors considered in determining to

³⁰ See, e.g., Securities Exchange Act Release No. 65455 (September 30, 2011), 76 FR 62119 (October 6, 2011) at 62120, n.16 and accompanying text.

acquire error positions into the error account, and associated with the liquidation of error positions through the third-party broker-dealer.³¹

Finally, the Commission notes that the proposed procedures for canceling orders and handling of error positions are consistent with procedures the Commission has approved for another exchange.³²

³¹ See EDGX Rule 2.11(a)(7).

³² See Securities Exchange Act Release No. 66963 (May 10, 2012), 77 FR 28919 (May 16, 2012) (SR-NYSEArca-2012-22).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³³ that the proposed rule change (SR-EDGX-2012-08) be, and it hereby is, approved.

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

Kevin M. O'Neill
Deputy Secretary

³³ 15 U.S.C. 78s(b)(2).

³⁴ 17 CFR 200.30-3(a)(12).