

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-70951; File No. SR-BYX-2013-036]

Self-Regulatory Organizations; BATS Y-Exchange, Inc.; Order Approving a Proposed Rule Change To Amend BYX Rule 12.6 To Conform to FINRA Rule 5320 Relating to Trading Ahead of Customer Orders

November 27, 2013.

I. Introduction

On October 3, 2013, BATS Y-Exchange, Inc. (the “Exchange” or “BYX”) filed with the Securities and Exchange Commission (“Commission” or “SEC”), 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 BYX Rule 12.6 (“Rule 12.6”) to make it substantially similar to Financial Industry Regulatory Authority (“FINRA”) Rule 5320. The proposed rule change was published for comment in the *Federal Register* on October 22, 2013.³ The Commission received no comments on the proposal. This order approves the proposed rule change.

II. Description of the Proposed Rule Change

The Exchange proposes to amend Rule 12.6, which limits trading ahead of customer orders by Members,⁴ to have the rule substantially conform to FINRA Rule 5320.⁵ As with FINRA Rule 5320, the proposed amendments to Rule 12.6 would prohibit Members from trading ahead of customer orders, subject to specified exceptions. Rule 12.6, as proposed to be amended, 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, described below. Rule 12.6 also would provide the same guidance as FINRA Rule 5320 with respect to 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 current 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 purpose of facilitating the execution, on a riskless principal basis, of one or more customer orders.

Proposal To Adopt Text of FINRA Rule 5320

To harmonize its rules with FINRA, 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 changes, as Rule 12.6. FINRA Rule 5320 generally provides that a FINRA member that accepts and holds an order in an equity security for 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

The proposed amendments to Rule 12.6 would include exceptions to the prohibition against trading ahead of customer orders. 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 forth 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” would be defined in accordance with FINRA Rule 4512(c). Accordingly, an institutional account would 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 to Rule 12.6, as amended, 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. In addition, 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.⁶

In lieu of providing written disclosure to customers at account opening and annually thereafter, Rule 12.6 would permit Members to provide clear and comprehensive oral disclosure to, and obtain consent from, a customer on an order-by-order basis. Under Rule 12.6, the Member would be required to document who provided such consent and that such consent evidenced the customer’s understanding of the terms and conditions of the order. If a customer opted in to the protections of Rule 12.6, 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 also proposes to include in Interpretation and Policy .02 a “no-knowledge” exception to Rule 12.6. 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

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 70663 (October 11, 2013), 78 FR 62896 (SR-BYX-2013-036) (“Notice”).

⁴ Members are registered brokers or dealers that have been admitted to membership at the Exchange. BYX Rule 1.5(n).

⁵ See Securities Exchange Act Release No. 63895 (February 11, 2011), 76 FR 9386 (February 17, 2011) (SR-FINRA-2009-90).

⁶ 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 would be subject to further instruction and modification from the customer.

Exception"). The No-Knowledge Exception would be applicable with respect to NMS stocks, as defined in Rule 600 of Regulation NMS under the Act.

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 would 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. Under the proposed exception, the onus would 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 issue a regulatory notice informing Members of the proposed revisions to Rule 12.6. The Exchange will include in the regulatory notice the effective date for the rule as amended, which shall be at least 30 days after Commission approval of the proposed amendments to Rule 12.6 in order to allow Members to make any necessary changes to their internal policies or processes.

Riskless Principal Exception

Another proposed amendment to 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 a Member relies in claiming this exception.

ISO Exception

A further proposed amendment to Rule 12.6 would 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 with respect to the consenting customer's order.

Odd Lot and Bona Fide Error Exception

The Exchange also proposes to except a Member's proprietary trade that: (1) Offsets a customer odd lot order (*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 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 exception, the Exchange would adopt the definition of "bona fide error" found in Regulation NMS's exemption for error correction transactions.⁷ Thus, a bona fide error would be:

(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.⁸

Minimum Price Improvement Standards

The proposed rule change also would establish 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 the amended Rule, even if those better-priced limit orders would not be directly triggered under these minimum price improvement standards.

Order Handling Procedures

The proposed rule change would provide 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 Rule 12.6, as amended, and with the terms of the orders. A Member could satisfy the crossing requirement by contemporaneously buying from the

⁷ 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).

⁸ *Id.*

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 Rule 12.6, as amended, would apply to that customer's order at all times the customer order is executable by the Member.

III. Discussion and Commission Findings

After careful review of the proposed rule change, the Commission finds that the Exchange's proposal is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.⁹ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹⁰ which requires that the rules of a national securities exchange be designed, among other things, 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.

The Commission believes that the proposed rule change, which is designed to establish a single standard to protect customer orders from member firms trading ahead of those orders, will help assure the protection of customer orders without imposing undue regulatory costs on industry participants. Moreover, the Commission believes that the proposed rule change will define important parameters by which Members must abide when trading proprietarily while holding customer orders. In addition, because the Exchange is proposing to make its customer order protection rule substantially similar to the customer order protection rules of FINRA¹¹ and other exchanges,¹² the Commission

believes that the proposed rule change will help reduce the complexity of the customer order protection rules for those firms subject to these rules. Taken together, the proposed rule change should provide Members with clarity and guidance and thereby promote the efficient functioning of the securities markets.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹³ that the proposed rule change (SR-BYX-2013-036) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁴

Kevin M. O'Neill,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-70957; File No. SR-FINRA-2013-037]

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, To Amend FINRA Rule 5131 (New Issue Allocations and Distributions)

November 27, 2013.

I. Introduction

On August 23, 2013, the Financial Industry Regulatory Authority, Inc. ("FINRA") 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 FINRA Rule 5131 (New Issue Allocations and Distributions) to provide a limited exception to allow members to rely on written representations from certain accounts to comply with Rule 5131(b). The proposed rule change was

Exchange Act Release No. 65165 (August 18, 2011), 76 FR 53009 (August 24, 2011) (SR-NYSEAmex-2011-59); Securities Exchange Act Release No. 65166 (August 18, 2011), 76 FR 53012 (August 24, 2011) (SR-NYSEArca-2011-57); Securities Exchange Act Release No. 69504 (May 2, 2013), 78 FR 26828 (May 8, 2013) (SR-CBOE-2013-027); and Securities Exchange Act Release No. 70011 (July 19, 2013), 78 FR 44994 (July 25, 2013) (SR-CBOE-2013-074).

¹³ 15 U.S.C. 78s(b)(2).

¹⁴ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

published for comment in the **Federal Register** on September 10, 2013.³ The Commission received two comment letters in response to the proposed rule change.⁴ On November 22, 2013, FINRA filed Amendment No. 1 with the Commission to respond to the comment letters and to propose a clarifying modification to the proposed exception regarding the eligibility of an unaffiliated private fund where a control person of the fund's investment adviser also is a beneficial owner in the fund. The Commission is publishing this notice and order to solicit comments on Amendment No. 1 and to approve the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

II. Description of Proposal

On August 23, 2013, FINRA filed the Original Proposal to amend FINRA Rule 5131 to provide a limited exception to allow members to rely on written representations from certain accounts in complying with FINRA Rule 5131(b) (the "spinning provision").⁵

FINRA Rule 5131 addresses abuses in the allocation and distribution of "new issues,"⁶ and paragraph (b) prohibits the practice of "spinning," which refers to an underwriter's allocation of new issue shares to executive officers and directors of a company as an inducement to award the underwriter with investment banking business, or as consideration for investment banking business previously awarded.

The spinning provision generally provides that no member or person associated with a member may allocate shares of a new issue to any account in which an executive officer or director of a public company⁷ or a covered non-public company,⁸ or a person materially

³ See Securities Exchange Act Release No. 70312 (Sept. 4, 2013), 78 FR 55322 (Sept. 10, 2013) (Notice of Filing of SR-FINRA-2013-037) ("Original Proposal"). The comment period ended on October 1, 2013.

⁴ See letter to Elizabeth M. Murphy, Secretary, Commission, from William G. Mulligan, CEO, Cordium US., dated Oct. 1, 2013 ("Cordium letter"); and letter to Elizabeth M. Murphy, Secretary, Commission, from Stuart J. Kaswell, Executive Vice President & Managing Director, Managed Funds Association, dated Sept. 30, 2013 ("MFA letter"). The letters are available on the Commission's Web site at <http://www.sec.gov/comments/sr-finra-2013-037/finra2013037.shtml>.

⁵ See *supra* note 3.

⁶ The term "new issue" has the same meaning as in Rule 5130(i)(9). See Rule 5130(i)(9).

⁷ A "public company" is any company that is registered under Section 12 of the Act or files periodic reports pursuant to Section 15(d) thereof. See Rule 5131(e)(1).

⁸ The term "covered non-public company" means any non-public company satisfying the following criteria: (i) Income of at least \$1 million in the last fiscal year or in two of the last three fiscal years

⁹ In approving the BYX proposed rule change, the Commission has considered its impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

¹⁰ 15 U.S.C. 78f(b)(5).

¹¹ See FINRA Rule 5320, *supra* note 5.

¹² Several national securities exchanges submitted proposed rule changes to adopt customer order protection rules that are substantially similar to FINRA Rule 5320. See, e.g., Securities Exchange Act Release No. 64418 (May 6, 2011), 76 FR 27735 (May 12, 2011) (SR-CHX-2011-08); Securities