



BZX Regulatory Circular 13-005
BYX Regulatory Circular 13-005

Date: December 11, 2013

To: Members of BATS Exchange, Inc. and BATS Y-Exchange, Inc.

From: Membership Services

Re: SEC Approval of Rule Prohibiting Trading Ahead of Customer Orders

BATS Exchange, Inc. ("BZX") and BATS Y-Exchange, Inc. ("BYX", and collectively with BZX each referred to as the "Exchanges") would like to inform its Members of recent changes to Rule 12.6, formerly entitled "Customer Priority" and now entitled "Prohibition Against Trading Ahead of Customer Orders." The changes adopted to Rule 12.6 make such Rule substantially the same as FINRA Rule 5320. The effective date of the revised Rule is January 2, 2014.

Under the Rule as amended and subject to exceptions described below, a Member that accepts and holds an order in an equity security from a customer (whether the Member's own customer or the customer of another broker-dealer) without immediately executing this order cannot trade that same security on the other side of the market for the Member's own account at a price that would satisfy the customer order, unless the Member 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.¹ Members must also have written a written methodology regarding the execution and priority of all pending orders consistent with the requirements of the Rule and ensure that this methodology is consistently applied.²

Exceptions for Large Orders and Institutional Accounts

Pursuant to Interpretation and Policy .01 to Rule 12.6, Members may trade ahead of or along with those customer orders from institutional accounts or those orders of 10,000 shares or more, so long as these large orders are worth at least \$100,000. However, to fall within this exception, Members must provide their customers with clear and comprehensive written disclosures at the time they open the account and annually thereafter. These disclosures must inform the customer that the Member may trade for its own account at prices that would satisfy their orders and provide customers with a meaningful opportunity to "opt-in" to the protections of Rule 12.6 with respect to all or any portion of their orders. If a customer does not opt-in to the protections of Rule 12.6, the Member may reasonably conclude that such customer has consented to the Member trading a security for its own account on the same side of the market and at a price that would satisfy the customer's order.

A Member may choose to make clear and comprehensive oral, as opposed to written disclosures, to their customers, so long as the Member makes these oral disclosures and

¹ Rule 12.6(a).

² Rule 12.6(b).

receives consent from the customer to trade proprietarily on an order-by-order basis, records who provides this consent, and the consent evidences that the customer understands 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.

For the purposes of Rule 12.6, an institutional account is defined as the account of: (1) a bank savings and loan association, insurance company or registered investment company; (2) an investment adviser register 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.

The "No-Knowledge" Exception

Under Rule 12.6, Interpretation and Policy .02, if a Member implements and utilizes an effective system of internal controls that prevent one trading unit from obtaining knowledge of customer orders held by a separate trading unit, proprietary trading units may continue to trade ahead of or along with customer orders held by separate trading units. Those trading units that would trade at prices that would satisfy customer orders held by separate units must make written disclosures to customers at account opening and annually thereafter that provide a description of the way in which customer orders are handled and the circumstances under which a trading unit might trade proprietarily, including in a market-making capacity, at prices that would satisfy the customer order.³

Members that implement and utilize appropriate information barriers must uniquely identify those barriers in place at the department in the Member firm that receives or originates orders.⁴ Further, appropriate information barriers will, at a minimum comply with the requirements set forth in Rule 5.5. Rule 5.5 requires each Member to establish, maintain, and enforce written procedures reasonably designed to prevent the misuse of material, non-public information by the Member or associated persons.⁵

Members must also maintain records that indicate which orders rely on the No-Knowledge Exception and submit these records to the Exchange upon request.

This exception applies to trading in NMS stocks, as defined in Rule 600 of Regulation NMS under the Securities Exchange Act.⁶

³ See Rule 12.6, Interpretation and Policy .02(a).

⁴ See Rule 12.6, Interpretation and Policy .02(b).

⁵ Interpretation and Policy .02 to Rule 5.5 sets forth the minimum standards for the policies and procedures required by the Rule.

⁶ 17 C.F.R. § 242.600(b)(47).

The Riskless Principal Exception

Interpretation and Policy .03 to Rule 12.6 provides that a Member may trade proprietarily without violating Rule 12.6 if such trade is for the purposes of facilitating the execution, on a riskless principal basis, of a customer order ("facilitated order"). To take advantage of this exception, the member must submit a report to the Exchange, contemporaneously with the execution of the facilitated order, identifying the trade as riskless principal, and the Member must have written policies and procedures in place that ensure that riskless principal transactions that rely on this Exception comply with Exchange Rules. At a minimum, these policies and procedures must require customer orders to be received before the offsetting principal transaction and that the offsetting principal transaction is at the same price as the customer order exclusive of any markup, markdown, commission equivalent, or other fee, and is allocated to a riskless principal or customer account in a consistent manner and within 60 seconds of execution.

Members that utilize this exception must have supervisory systems in place that produce records enabling the Member and the Exchange to reconstruct accurately, readily, and in a time-sequenced manner all facilitated orders made in reliance on the exception.

ISO Exception

Pursuant to Rule 12.6, Interpretation and Policy .04, a Member is exempt from its obligations under Rule 12.6 with regard to trading for its own account that is the result of an intermarket sweep order ("ISO") routed in compliance with Rule 600(b)(30)(ii) of Regulation NMS⁷ where the customer order is received after the Member routed the ISO. A Member's proprietary trading is also exempt with respect to an ISO that is routed to facilitate a customer order where the customer has consented to not receiving the better prices obtained by the ISO.

Odd Lot and Bona Fide Error Transaction Exceptions

In accordance with Interpretation and Policy .05, a Member is also exempted from its obligations under Rule 12.6 for proprietary trades that are made to offset a customer order that is less than a normal unit of trading ("odd lot") or to correct a bona fide error. If relying on the Bona Fide Error Exception, the Member must demonstrate and document the basis for meeting the exception.

For purposes of the Bona Fide Error Exception, a bona fide error is:

- (a) 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;
- (b) The unauthorized or unintended purchase, sale, or allocation of securities or the failure to follow specific client instructions;
- (c) The incorrect entry of data into relevant systems, including reliance on incorrect cash position, withdrawals, or securities positions reflected in an account; or

⁷ 17 C.F.R. § 242.600(b)(30)(ii).

- (d) 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.

Minimum Price Improvement Standards

Interpretation and Policy .06 to Rule 12.6 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 the same security without being required to execute the held limit order. If the minimum price improvement standards would trigger the protection of a pending customer order, any better-priced customer limit order(s) would also be protected under Rule 12.6 even if those better-priced limit orders would not directly trigger these protections under the minimum price improvement standards enumerated in the Rule.

Order Handling Procedures

Pursuant to Interpretation and Policy .07 to Rule 12.6, a Member must make every effort to execute a marketable customer order that it receives fully and promptly. A Member that is holding a customer order that is marketable and has not been immediately executed must 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. In the event that a Member is holding multiple orders on both sides of the market that have not been executed, the Member must make every effort to cross or otherwise execute such orders in a manner that is reasonable and consistent with the objectives of this Rule and with the terms of the orders. A Member can satisfy the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price.

Trading Outside of Normal Market Hours

Interpretation and Policy .08 to Rule 12.6 makes clear that a Member generally may limit the life of a customer order to normal market hours (9:30 am to 4:00 pm Eastern Time). However, if a Member and its customer agree to allow process of the customer's order outside of normal market hours, the protections of Rule 12.6 will apply to the customer's order at all times the customer order is executable by the Member.