



Direct Edge Regulatory Notice #11-01: Market Making Rules and Obligations

Introduction

This Regulatory Notice ("Notice") serves to remind and inform the Members of EDGA Exchange and EDGX Exchange (each, an "Exchange", and together, the "Exchanges") that those portions of Rule 15c3-5 (the "Market Access Rule" or the "Rule") under the Securities Exchange Act of 1934 (the "Exchange Act") that did not take effect on July 14, 2011, become effective today, **November 30, 2011**. The purpose of this Notice is to remind Members of their obligations under the Market Access Rule, and to describe the risk management controls that the Exchanges, along with their routing facility DE Route, have established with a view to managing the potential financial, regulatory and other risks associated with providing Members with access to our Exchanges and to external market centers via DE Route.

Scope and Description of Market Access Rule

The Market Access Rule was adopted by the Securities and Exchange Commission (the "SEC") in an effort to reduce the risks associated with providing market participants with access to the marketplace. Among other things, the Rule requires that any broker-dealer with market access,ⁱ or that provides a customer or any other person with access to an exchange or alternative trading system through use of its market participant identifier ("MPID") or otherwise, must establish, document and maintain a system of risk management controls and supervisory procedures that are reasonably designed to manage the financial, regulatory and other risks of this business activity.

These controls include financial risk management controls reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and the broker-dealer itself,ⁱⁱ and to prevent the entry of erroneous orders. In addition, the Rule requires certain regulatory risk management controls that, among other things, prevent the entry of orders unless compliance with applicable regulatory requirements has been satisfied on a pre-order entry basis, and restrict access to trading systems and technology that provide market access to persons and accounts

ⁱ The term "market access" is defined in paragraph (a)(1) of the Rule to mean access to trading in securities on an exchange or alternative trading system ("ATS") as a result of being a member or subscriber of the exchange or ATS, respectively, or access to trading in securities on an ATS provided by a broker-dealer operator of an ATS to a non-broker-dealer.

ⁱⁱ The compliance date within which broker-dealers having or providing market access were required to establish controls and supervisory procedures reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and for the broker-dealer itself was deferred by the SEC until November 30, 2011. See <http://www.sec.gov/rules/final/2011/34-64748.pdf>.

that have been pre-approved and authorized by the broker-dealer. These risk management controls and associated supervisory procedures must be under the direct and exclusive control of the broker-dealer that is subject to the Rule.

I. Member Obligations under Market Access Rule

Among other requirements, Members who have or provide market access, as defined under the Rule, are required to establish, document and maintain a system of risk management controls and supervisory procedures. Such Members must preserve a copy of such supervisory procedures and a written description of controls in accordance with applicable books and records provisions in Rule 17a-4 under the Exchange Act. In addition, Members must assure that appropriate surveillance personnel receive immediate, post-trade execution reports that result from market access. And, Members must establish, document and maintain a system for regularly reviewing (no less than annually) the effectiveness of the risk management controls and supervisory procedures. To that end, the Chief Executive Officer of the Member must annually certify that the controls and procedures required by the Rule are in compliance with the Rule, and that the Member conducted the aforementioned review.

II. Description of Exchanges' Risk Management Controls Pursuant to Rule

The Exchanges utilize a routing broker-dealer, DE Route, to access other exchanges and market centers to attempt to execute eligible Member orders. As a broker-dealer with market access, therefore, the Market Access Rule applies to DE Route. Accordingly, Members that submit routing-eligible orders to one or both of the Exchanges will be subject to the following financial and regulatory risk management controls in accordance with the Rule.

A. Financial Risk Management Controls

1. Prevention of Orders Exceeding Pre-Set Credit/Capital Thresholds

To comply with the requirement to implement controls to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer, each Exchange has established a four-tier hierarchy based on an analysis of each Member's average daily routed notional share volume over a historical period of time. Every Member will be initially assigned to one of the tiers. The tier will determine that Member's Daily Credit Limit, which will be applied on a pre-order entry basis to all "non-exempt" orders (which means they apply to all orders other than those that can only be executed on the Exchange to which it was transmitted or can only be routed to another market center for the sole purpose of accessing a Protected Quotation pursuant to Rule 611 of Regulation NMS under the Exchange Act).

The Exchanges' Market Operations department will endeavor to contact Members if and to the extent that their activity reaches 50%, 75% and 90% of their Daily Credit Limit, and will entertain requests for a

higher tier size, whether for the remainder of the day or permanently, under certain circumstances. Otherwise, a breach of a Member's Daily Credit Limit will result in the cancellation of all non-exempt orders that are not executed on the Exchange on which it was entered for the remainder of the trading day.

2. Prevention of Erroneous Orders

To comply with the requirement to implement controls to prevent the entry of erroneous orders, the Exchanges will reject orders that exceed certain parameters over a short period of time ("SPOT"). Each Member's SPOT Limit will represent a certain percentage of that Member's Daily Credit Limit, with a slightly higher SPOT Limit at the opening/close of the trading day. Over the course of the trading day, the Exchanges will continuously monitor the total notional dollar value of all routable orders from each Member on a pre-order entry basis over a rolling time interval. The purpose of this risk control is to prevent Member activity that is significantly out of line with past trading patterns by that Member. This "short period of time" application will apply only to the portion of any order that is routed outbound. Members sending "book only" or "non-routable" strategies will not be subject to such tests.

If a Member submits an order that causes a breach of the Member's SPOT Limit during a given time interval, the order that caused the breach would be eligible for execution. However, any additional routable orders of the Member that are entered on the Exchange whose SPOT Limit was breached during the remainder of that trading day, which are not executed on that Exchange, will be cancelled back to the Member. In those circumstances, the Exchanges' Market Operations department will endeavor to contact the Member to determine whether appropriate circumstances exist to justify reinstating routable orders from the Member during the balance of that trading day, including by increasing the SPOT Limit (and, therefore the Daily Credit Limit) on an intraday or permanent basis.

B. Regulatory Risk Management Controls

Certain regulatory risk management controls are imposed to prevent the entry of orders unless compliance with applicable regulatory requirements has been satisfied on a pre-order entry basis. These include, for example, ensuring that order instructions are clear (and also comply with special order type instruction of other market centers) and orders are properly marked. While the Rule only requires these controls to be imposed on non-exempt orders, the Exchanges apply most of these controls to all orders submitted to the Exchanges.

In addition, while it is primarily a Member's responsibility to restrict access to its trading systems and technology to authorized personnel, the Exchanges nonetheless employ reasonable measures to prevent access to unauthorized persons or accounts by requesting and maintaining Authorized Trader ("AT") lists and assigning ATs with individual logins and IP ports. Moreover, all new Members are required to conduct certification testing with the Exchanges' FIX Support group and are prevented from accessing any production environment until certification has been deemed successful.

Exchanges' Risk Management Controls Applicable to All Member Orders

Notwithstanding the Market Access Rule, the Exchanges, as a matter of prudent risk management and market integrity, impose a series of price and size threshold limits on all Member orders (i.e., order-by-order) on a pre-order entry basis.

1. Price Thresholds

Limit thresholds (in dollars) The Exchanges apply limit price checks that reject any order whose limit price exceeds a set dollar price away from the National Best Bid (the "NBB") or National Best Offer (the "NBO", and together with the NBB, the "NBBO") at time of entry. The thresholds will vary by the price of the stock according to the following table:

NBBO range (opposite side)	Limit price trigger (limit price =x)
Price < \$1	x >= \$0.75
>=\$1 Price < \$10	x >= \$1.00
>=\$10 Price <\$50	x >= \$5.00
>=\$50 Price <\$100	x >= \$10.00
>=\$100 Price <\$500	x >= \$25.00
Price >=\$500	x >= \$50.00

Example 1:

NBBO at time of entry: 9.98 X 9.99

Member submits limit order to buy 10,000 at \$10.99 (or higher).

Parameter logic and result:

- Logic looks at order's limit price (\$10.99) and compares to opposite side NBO (in this case, \$9.99).
- Since NBO at time of receipt equals \$9.99, the limit price trigger will reject any order whose limit is >=\$10.99.
- Submitted order is rejected.

Example 2:

NBBO at time of entry: 49.00 x 50.00

Member submits limit order to buy 10,000 at \$55.50. Parameter logic and result:

- Logic looks at order's limit price (\$55.50) and compares to opposite side NBO (in this case, \$50.00).
- Since NBO at time of receipt equals \$50.00, the limit price trigger will reject any order whose limit is $\geq \$60.00$.
- Submitted order is accepted.

These limit thresholds are controlled on a Member's ports (FIX or High Performance API) to both Exchanges.

The limit price triggers in the table above are the default settings for all Members. Upon request, Members can request to reduce the price triggers to more restrictive values; however, Members cannot choose to increase the price triggers to less restrictive values.

Limit thresholds (as a percentage away from NBBO)

The Exchanges also apply limit price checks that reject any order whose limit price exceeds a set percentage away from the NBBO at time of entry. The thresholds will vary by the price of the stock according to the following table:

NBBO range (opposite side)	"Percentage through" trigger (where x = limit's price percentage through the NBBO)
Price < \$1	x \geq 75%
$\geq \$1$ Price < \$10	x \geq 50%
$\geq \$10$ Price < \$50	x \geq 20%
$\geq \$50$ Price < \$100	x \geq 20%
$\geq \$100$ Price < \$500	x \geq 20%
Price $\geq \$500$	x \geq 20%

Example 1:

NBBO at time of entry: 9.98 X 9.99

Member submits limit order to buy 10,000 at \$10.99 (or higher).

Parameter logic and result:

- Logic looks at order's limit price (\$10.99) and compares to opposite side NBO (in this case, \$9.99).

- Since NBO at time of receipt equals \$9.99, the “percent through” trigger will reject any order whose limit is $\geq \$14.99$ (orders priced greater than 50% through the NBBO).
- Submitted order is accepted.

Example 2:

NBBO at time of entry: 49.00 x 50.00

Member submits limit order to buy 10,000 at \$55.50.

Parameter logic and result:

- Logic looks at order's limit price (\$55.50) and compares to opposite side NBO (in this case, \$50.00).
- Since NBO at time of receipt equals \$50.00, the limit price trigger will reject any order whose limit is $\geq \$60.00$ (orders priced greater than 20% through the NBBO).
- Submitted order is accepted.

These limit thresholds are controlled on a Member's ports (FIX or High Performance API) to both Exchanges.

The “percent through” triggers in the table above are the default settings for all Members. Upon request, Members can request to reduce the percentage triggers to more restrictive values; however, Members cannot choose to increase the percentage triggers to less restrictive values.

Note: The limit thresholds (price and percentage through triggers) are two separate settings. Both settings are applied to a Member's port. Both parameters are used as checks against an inbound order, and if either one is breached, the order will be rejected. The Exchanges will apply the more restrictive check.

Example 3:

NBBO at time of entry: 9.98 X 9.99

Member has default price and percentage through triggers set.

Member submits limit order to buy 10,000 at \$10.99. Parameter logic and result:

- Logic looks at order's limit price (\$10.99) and compares to opposite side NBO (in this case, \$9.99).
- Since NBO at time of receipt equals \$9.99, the limit price trigger will look to reject any order whose limit is $\geq \$10.99$.
- Logic also looks at the order's limit price and compares to the opposite side NBO to determine if it breaches the “percentage through” threshold.

- The logic will look to reject any order whose limit is $\geq 50\%$ through the inside (14.99 in this example).
- The logic applies the more restrictive check (limit price) and thus rejects the order.

2. Size Thresholds

The size thresholds establish a maximum share size for each order and are intended to prevent the acceptance of large, erroneous trades. The default setting per order size threshold has been set to 999,999 shares for all Member sessions. A Member may freely request to reduce this threshold, but the maximum allowable increase is to 20,000,000 shares per order, subject to approval by the Exchanges' management. All orders outside approved parameters will be rejected.

Example 1:

Member submits limit order to buy 999,999 shares at \$10.99

Member's size threshold is defaulted at 999,999

Parameter logic and result:

- Order quantity (999,999) is no greater than the order default threshold size
- Order is accepted

Example 2:

Member submits limit order to buy 1,000,000 shares at \$10.99

Member's size threshold is defaulted at 999,999

Parameter logic and result:

- Order quantity (1,000,000) is greater than order default threshold size
- Order is rejected

The notional value thresholds are calculated as dollar figures that limit the total execution value of each order. The default per-order notional value threshold has been set to \$15,000,000 for all Member sessions. If an order's share quantity multiplied by its limit price exceeds the applicable notional value threshold, the order will be rejected. In the case of market orders, the prevailing NBO for buy orders, or NBB for sell orders, will be substituted for the limit price. A Member may freely request to decrease this threshold, but the maximum allowable increase is \$100,000,000 per order, and all increases require approval by the Exchanges' management. All orders outside approved parameters will be rejected.

Example 1:

Member submits limit order to buy 10,000 shares at \$10.99

Member's notional value threshold is defaulted at \$15,000,000

Parameter logic and result:

- Order's limit price (\$10.99) is multiplied by the share quantify (10,000) and the result is compared to the default notional value threshold (\$15,000,000)
- Order is accepted Example 2: Member submits market order to buy 10,000 shares NBBO at time of entry: \$9.98 x \$9.99 Member's notional value threshold is defaulted at \$15,000,000 Parameter logic and result:
- NBO (\$9.99) is multiplied by the share quantity (10,000) and the result is compared to the default notional value threshold (\$15,000,000)
- Order is accepted Example 3: Member submits market order to buy 30,000 shares NBBO at time of entry: \$530.00 x \$530.10 Member's notional value threshold is defaulted at \$15,000,000 Parameter logic and result:
- NBO (\$530.10) is multiplied by the share quantity (30,000) and the result is compared to the default notional value threshold (\$15,000,000)
- Order is rejected

4. **Duplicate Orders**

Client Order ID's are handled by the Exchanges' systems on a session by session basis. For any given Member session during a given trading day, any Order ID that has already been processed by the Exchanges, or remains on the Exchanges' books, will be rejected for the duration of that trading day.

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All questions regarding the Notice should be directed to your Direct Edge Member Services representative.