

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70214 / August 15, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15425

<p>In the Matter of</p> <p style="text-align:center">Chicago Stock Exchange, Inc.</p> <p>Respondent.</p>	<p>ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 19(h)(1) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934</p>
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I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 19(h)(1) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against the Chicago Stock Exchange, Inc. (“CHX” or “Respondent”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (“Offer”), which the Commission has determined to accept. Solely for the purposes of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 19(h)(1) and 21C of the Securities Exchange Act of 1934 (“Order”), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

Summary

From December 2006 to December 2010, CHX failed to implement policies and procedures reasonably designed to detect and prevent violations of Rule 611 of Regulation NMS¹ ("Rule 611"), the Order Protection Rule, in connection with the use of the Exchange's proprietary Validated Cross Trade Reporting Functionality ("validated cross system"). The validated cross system was intended to permit CHX institutional brokers ("IBs") to report certain trades executed outside of the Exchange's automated limit-order matching system and ensure that such trades complied with Rule 611. However, due to the flawed implementation of the system, it failed to prevent IBs from trading outside of the prevailing National Best Bid or Offer ("NBBO"), *i.e.*, from "trading through" the NBBO in violation of Rule 611. Moreover, from at least December 2006 to August 2008, CHX failed to implement surveillance procedures reasonably designed to monitor or enforce IB compliance with the Exchange's rules governing the use of the validated cross system.

As a result of the conduct described above, CHX failed to implement policies and procedures reasonably designed to detect and prevent improper trade-throughs, and failed to regularly surveil to ascertain the effectiveness of such policies and procedures and take prompt action to remedy any deficiencies, in violation of Rule 611. In addition, CHX failed to monitor and enforce compliance by its members with the Exchange's own rules in violation of Section 19(g)(1) of the Exchange Act.

Respondent

CHX, located in Chicago, Illinois, is a national securities exchange registered with the Commission pursuant to Section 6 of the Exchange Act. As of May 2013, approximately 0.4% of the national equities trading volume was transacted on CHX. In 2012, CHX reported revenues of \$17.1 million and net losses of \$1.5 million.

Facts

A. The Validated Cross System

In December 2006, CHX underwent a complete overhaul of its operations, eliminating its physical trading floor and converting to a fully automated trading platform. The automated limit-order matching system ("matching system") was the core facility of the Exchange's new trading model. Instead of a physical trading floor, Exchange participants from any location could submit orders to the matching system, where they would then be immediately executed or displayed (when eligible) in price-time priority. Although CHX anticipated that most IB trades would be executed on the Exchange's matching system, it also enabled IBs to execute cross trades—both proprietary and agency—outside of the matching system. These non-matching

¹ 17 CFR § 242.611

system transactions were also deemed to be “on the Exchange,” however, and as such, could not trade through either the Exchange’s book or the NBBO. The validated cross system, launched in December 2006, was intended to support the timely reporting of these non-matching system cross trades, while simultaneously ensuring (among other things) that these cross transactions did not trade through the prevailing NBBO in compliance with Rule 611.

The validated cross system was generally supposed to operate as follows. First, an IB would establish the material terms of the cross trade with its customer(s), *i.e.*, stock, price, and quantity. Then the IB would promptly open the validated cross window on its computer screen and enter the stock symbol into the proper data field. At the time that the IB moved to another data field, the validated cross window would capture and freeze a snapshot of the current NBBO and the Exchange’s book, and a timer would start. The IB would then fill in the other required fields, such as the quantity and price of shares, and submit the trade for reporting within a prescribed period of time.

CHX rules required IBs to use reasonable efforts to submit the trade within ten seconds, but the timer gave them, at various times, between 20 and 180 seconds to do so.² If the IB failed to submit the transaction within ten seconds, a “SOLD” modifier was affixed to the trade report, indicating that the trade was reported late.³ Once submitted, the system “validated” the transaction, *i.e.*, ensured that the proposed cross trade did not trade through the snapshot NBBO or the Exchange’s book. If the cross trade satisfied all requirements, the trade was accepted by the system and reported to the consolidated tape. If the cross trade failed to satisfy all requirements, then the trade was rejected.

However, if the IB did not fill in all of the required fields and submit the trade for reporting within the allotted time, the window would expire and the trade would not be processed. In addition, the validated cross window at various times permitted IBs to “refresh” (*i.e.*, obtain a new NBBO snapshot while preserving all other fields and restart the timer), “reset” (*i.e.*, clear all fields and restart the timer without closing the validated cross window), or “cancel” (*i.e.*, close the validated cross window without completing the transaction) the window. As discussed below, these features enabled some IBs to abuse the validated cross system by capturing an NBBO snapshot, watching the movement of the market, and then deciding whether to follow through with the execution at a price within the previously captured snapshot NBBO if the market had moved in favor of the position they were establishing (*i.e.*, up for buys and down for sells), or to cancel the transaction prior to completing the trade report and capture a new, more favorable snapshot NBBO if the market moved in the other direction.

² Initially, the window expiration timer gave IBs up to 90 seconds to complete a trade report. In January 2007, CHX extended the timer from 90 seconds to 180 seconds. In May 2008, CHX reduced the timer to 20 seconds.

³ Initially, the “SOLD” modifier was affixed after 10 seconds. In January 2007, CHX revised its rules to affix the “SOLD” modifier after 90 seconds, which was then the industry standard.

B. Article 17, Rule 3(e): CHX Rule Governing Use of Validated Cross System

In an effort to limit the opportunity for abuse that was afforded by the snapshot NBBO and the timing delays in the validated cross system, CHX adopted Article 17, Rule 3(e). Article 17, Rule 3(e) of the Exchange's rules required IBs that participated in a proprietary cross transaction to complete the transaction report without cancelling out the functionality (with narrow exceptions for, among other things, inputting the symbol for the wrong security or clearly erroneous trades), thus essentially locking in the trade once the snapshot NBBO was captured. In an October 16, 2006 Information Memorandum, CHX explained to its IBs that the purpose of the limitation was to "prevent the IB from cancelling a cross transaction prior to the completion of the trade report because the market moved in a direction favorable to the IB firm. . . ."

Article 17, Rule 3(e) also required IBs to use reasonable efforts to report all transactions that are not effected through the Exchange's matching system, *i.e.*, validated cross transactions, to the Exchange within ten seconds after the trade occurs. This requirement was intended to preserve the integrity of the validated cross system by preventing IBs from taking advantage of market movements over an extended period of time, and effectively provided assurances that IBs had in fact obtained agreement on the material terms of the trade prior to accessing the validated cross window. Due to deficiencies in its surveillance system, however, from December 2006 to August 2008, CHX had no means of reasonably enforcing IB compliance with either of these rule provisions.

C. Deficiencies in CHX Surveillance System

CHX failed to implement routine surveillance procedures to oversee the use of the validated cross system and to monitor for non-compliance with related rules for a period of over a year and a half. During the process of designing routine surveillance reports, CHX learned that the validated cross system could not reliably distinguish between cancellations of proprietary cross trades and cancellations of agency cross trades. As a result, CHX did not have the ability to monitor for IB compliance with Article 17, Rule 3(e), which set forth strict restrictions on the cancellation of proprietary cross trades. In January 2008, CHX resolved this problem by modifying the system to enable surveillance staff to separately analyze the cancellation of proprietary cross trades.

In August 2008, CHX finally implemented the first routine surveillance report for the validated cross system. This report identified cancellations of principal cross transactions that resulted in economic losses to the counterparty. In November 2008, CHX implemented a second routine surveillance report, which was designed to detect excessive cancellation of proprietary cross trades regardless of the impact on the counterparty. CHX never implemented a surveillance report to monitor for compliance with Article 17, Rule 3(e)'s requirement that IBs use reasonable efforts to report validated cross transactions within ten seconds of opening the validated cross window. In addition, CHX never implemented any surveillance reports designed to detect excessive cancellations and other improper activities in the context of agency cross trades.

D. Abuse of the Validated Cross System

Prior to the implementation of routine surveillance, CHX conducted several *ad hoc* surveillance reviews of the validated cross system. The first *ad hoc* review, which was conducted in November 2007—almost one year after the implementation of the system—showed high refresh and cancellation rates. The findings indicated that some IBs were not using the validated cross window in accordance with CHX guidance and rules. Subsequent *ad hoc* reviews—which resulted in two CHX enforcement actions⁴—confirmed that some IBs frequently violated Article 17, Rule 3(e), at times to the harm of their customers.

Moreover, in April 2008, CHX learned about abuse of the validated cross system from a broker-dealer that executed trades on the Exchange through a CHX IB. Specifically, the broker-dealer reported that some of its traders had repeatedly manipulated the validated cross system to execute trades that advantaged accounts held by hedge funds (which generally paid higher commissions) at the expense of accounts belonging to various employee stock purchase plans, employees stock option plans, and similar plans. At the trader’s direction, the IB would open the validated cross window, capture the snapshot NBBO for a particular security, and then watch how the market moved for that security. If the price moved in a direction that was favorable to the hedge fund, the IB used the ability to refresh the NBBO to chase better prices for the hedge fund. If the market moved against the hedge fund, the IB executed the trades at the stale snapshot NBBO.⁵

Notwithstanding these red flags, CHX failed to implement effective surveillance procedures reasonably designed to prevent abuses of the validated cross system. In December 2010, CHX decommissioned the validated cross system.

E. Violations

Section 19(g)(1) of the Exchange Act

Section 19(g)(1) of the Exchange Act requires every exchange to comply with the provisions of the Exchange Act, the rules and regulations thereunder, and its own rules, and, absent reasonable justification or excuse, to enforce compliance by its members with such provisions. The Commission has consistently stated that an exchange’s obligation to enforce compliance under Section 19(g)(1) “necessarily includes an obligation to monitor and maintain surveillance over its members.”⁶ An exchange violates Section 19(g)(1) when it fails “to be

⁴ *In the Matter of Dougall and Associates, Inc. and James Hennessey, Jr.*, CHX-D-2009-01 (May 6, 2009); *In the Matter of E*Trade Capital Markets, LLC*, CHX-D-2010-02 (Sept. 16, 2010).

⁵ This information resulted in two Commission enforcement actions and one CHX enforcement action. *See In the Matter of Mark Shaw*, Securities Act Release No. 9174 (Jan. 14, 2011); *In the Matter of BNY Mellon Securities, LLC*, Exchange Act Rel. No. 63724 (Jan. 14, 2011); *In the Matter of Lyall Securities*, CHX-D-2008-04 (Dec. 31, 2008).

⁶ *In the Matter of Boston Stock Exchange, Inc. and James B. Crofwell.*, Exchange Act Rel. No. 56352 (Sept. 5, 2007) (citations omitted).

vigilant in surveilling for, evaluating, and effectively addressing issues that could involve violations of its own rules.”⁷

As discussed above, from December 2006 to January 2008, CHX could not reliably distinguish between the cancellation of proprietary cross trades and the cancellation of agency cross trades, and thus had no ability to monitor or enforce IB compliance with Article 17, Rule 3(e). In addition, from December 2006 to August 2008, CHX failed to implement routine surveillance procedures to identify potential violations of Article 17, Rule 3(e) of the Exchange’s rules. Finally, CHX never formally monitored for compliance with Article 17, Rule 3(e)’s requirement that IBs use reasonable efforts to report transactions within 10 seconds. CHX thus violated Section 19(g)(1) of the Exchange Act by failing to enforce compliance with Article 17, Rule 3(e) of the Exchange’s rules without reasonable justification or excuse.

Violation of Rule 611 of Regulation NMS

Rule 611 of Regulation NMS is intended to prevent the occurrences of trade-throughs. A trade-through occurs when a “trading center,” such as CHX, executes an order at a price that is inferior to a “protected quotation.” A “protected quotation” is the best automated bid or offer displayed by a national securities exchange, and is commonly referred to as the NBBO. Rule 611(a)(1) specifically provides that a “trading center” shall:

establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs on that trading center of protected quotations in NMS stocks that do not fall within an exception set forth in paragraph (b) of this section and, if relying on such an exception, that are reasonably designed to assure compliance with the terms of the exception.

In addition, Rule 611(a)(2) requires trading centers to:

regularly surveil to ascertain the effectiveness of the policies and procedures required by paragraph (a)(1) of this section and shall take prompt action to remedy deficiencies in such policies and procedures.

As discussed above, the validated cross system permitted IBs to execute transactions at stale prices within previously captured NBBOs. The system was thus not reasonably designed to prevent validated cross trades from trading through the NBBO prevailing at the time of execution. Moreover, CHX failed to enforce rules that were designed to limit the opportunities for abuse of the validated cross system. As a result, CHX failed to establish, maintain, or enforce policies and procedures reasonably designed to prevent trade-throughs, or regularly surveil to ascertain the effectiveness of such policies and procedures, in violation of Rule 611.

⁷ *Id.*

F. Remedial Efforts

In determining to accept the Offer, the Commission considered the remedial acts undertaken by CHX, including the Exchange's repeated efforts to improve its surveillance of the validated cross system and its ultimate discontinuation of the system. The Commission also considered the Exchange's efforts to improve its regulatory program, including its voluntary retention of outside consultants to conduct reviews of its surveillance and enforcement programs, its augmentation of its regulatory staff, and its investments in automated surveillance tools. Finally, the Commission credits the Exchange's assistance with the Commission's enforcement actions against Mark Shaw and BNY Mellon Securities, LLC.⁸ Under these circumstances, the Commission has determined that it is not in the public interest to impose additional limitations upon the activities, functions, or operations of CHX pursuant to Section 19(h)(1) of the Exchange Act.

IV.

In view of the foregoing, the Commission deems it necessary and appropriate in the public interest, and for the protection of investors, to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 19(h)(1) and 21C of the Exchange Act, it is hereby ORDERED that:

- A. Respondent be, and hereby is, censured;
- B. Respondent cease and desist from committing or causing any violations and any future violations of Section 19(g)(1) of the Exchange Act and Rule 611 of Regulation NMS; and
- C. Pursuant to Section 21B(a)(2) of the Exchange Act, Respondent shall within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of \$300,000 (three hundred thousand dollars) to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Payment must be made in one of the following ways: (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) Respondent may make direct payment from a bank account via pay.gov through the SEC website at www.sec.gov/about/offices/ofm.htm; or (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

⁸ See *supra* note 5.

Payment by check or money order must be accompanied by a cover letter identifying CHX as a Respondent in these proceedings and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to C.J. Kerstetter, Assistant Regional Director, Chicago Regional Office, Securities and Exchange Commission, 175 West Jackson Boulevard, Suite 900, Chicago, IL 60604.

By the Commission.

Elizabeth M. Murphy
Secretary