



OFFICE OF THE  
INVESTOR ADVOCATE

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

**\* MEMORANDUM \***

**TO:** U.S. Securities and Exchange Commission

**FROM:** Rick A. Fleming, Investor Advocate<sup>1</sup>

**DATE:** December 15, 2015

**RE:** Recommendation of the Investor Advocate  
File No. SR-BATS-2015-101

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**RECOMMENDATION:**

*Approve the proposal from BATS Exchange, Inc. to adopt new BATS Rule 8.17 to provide a process for an expedited suspension proceeding and new BATS Rule 12.15 to prohibit disruptive quoting and trading activity on the BATS Exchange, Inc.*

**I. Introduction**

Pursuant to Section 4(g)(4) of the Securities Exchange Act of 1934 (“Exchange Act”),<sup>2</sup> the Office of the Investor Advocate at the U.S. Securities and Exchange Commission (“Commission” or “SEC”) is responsible for, among other things, analyzing the potential impact on investors of proposed rules of self-regulatory organizations (“SROs”). In furtherance of this objective, we routinely review and examine the impact on investors of significant rulemakings of SROs, including the BATS Exchange, Inc. (“BATS” or the “Exchange”). As appropriate, we make recommendations to help ensure that the interests of investors are fully considered as rules

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<sup>1</sup> This Recommendation expresses solely the views of the Investor Advocate. It does not necessarily reflect the views of the Commission, the Commissioners, or staff of the Commission, and the Commission disclaims responsibility for all analyses, findings, and conclusions contained herein.

<sup>2</sup> 15 U.S.C. § 78d(g)(4).

are adopted. As identified in our Report on Objectives for Fiscal Year 2016, we are focusing on initiatives involving equity market structure reforms that may impact investors.<sup>3</sup>

In File No. SR-BATS-2015-101 (the “Notice”),<sup>4</sup> BATS has proposed to give itself the authority to initiate an expedited suspension proceeding in order to stop certain cases of disruptive and manipulative trading behavior. As proposed, BATS Rule 12.15 would clarify that certain disruptive quoting and trading activity, specifically those containing many of the elements indicative of spoofing and layering,<sup>5</sup> are considered manipulative trading activity and are prohibited on the Exchange. In addition, proposed BATS Rule 8.17 would provide an expedited process to halt the misconduct. In particular, BATS Rule 8.17 would allow the Exchange to issue a suspension order in which it prohibits the member broker-dealer from conducting such activity and requires the member to cease and desist from granting market access to a manipulative trader.

The Exchange will provide notice initiating a suspension proceeding, with such notice containing a description of acts that constitute the alleged violation. A hearing panel will then hold a hearing not later than 15 days after service of the notice, and that panel will issue a written

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<sup>3</sup> See Office of the Investor Advocate, Report on Objectives for Fiscal Year 2016, June 30, 2015, *available at* <http://www.sec.gov/advocate/reportspubs/annual-reports/sec-office-investor-advocate-report-on-objectives-fy2016.pdf>.

<sup>4</sup> Securities Exchange Act Release No. 76470 [November 18, 2015], 80 FR 5073247 [November 24, 2015], File No. SR-BATS-2015-101, *available at* <http://www.gpo.gov/fdsys/pkg/FR-2015-11-24/pdf/2015-29843.pdf>. As described in the Notice, the proposal reflects enhancements to a prior filing. See Securities Exchange Act Release No. 75693 [August 13, 2015], 80 FR 50370 [August 19, 2015], File No. SR-BATS-2015-57, *available at* <http://www.gpo.gov/fdsys/pkg/FR-2015-08-19/pdf/2015-20421.pdf>; see also Letter to Brent J. Fields, Secretary, Commission, from Anders Franzon, VP, Associate General Counsel, BATS, dated Nov. 6, 2015, *available at* <http://www.sec.gov/comments/sr-bats-2015-57/bats201557-6.pdf>.

<sup>5</sup> See *infra* notes 8 and 9. As explained in the Notice, BATS proposes to define the prohibited “disruptive quoting and trading activity” by modifying its traditional definitions of “layering” and “spoofing” to eliminate an express intent element that would not be proven on an expedited basis. See *supra* note 4. The Exchange believes it is necessary for the protection of investors to make such modifications in order to adopt an expedited process but does not intend to modify the definitions of spoofing and layering that have generally been used by the Exchange and other regulators in connection with prior enforcement matters. *Id.*

decision, not later than 10 days after receipt of a hearing transcript, stating whether a suspension order shall be imposed. Such suspension will only be imposed if the hearing panel finds by a preponderance of the evidence that the alleged violation specified in the notice has occurred and that the conduct is likely to result in significant market disruption or other harm to investors. The member may apply to the hearing panel to have the order reviewed in part or in full, and may also seek to have the order reviewed by the Commission under Section 19 of the Exchange Act.

The Office of the Investor Advocate has reviewed the Exchange's proposed rules. In short, we support the Exchange's efforts to promptly initiate and quickly resolve obvious and uncomplicated matters the Exchange believes involve disruptive and manipulative trading activity. Accordingly, we recommend that the Commission approve, either directly or through authority delegated to staff,<sup>6</sup> the Exchange's proposed rule change. Although our recommendation relates specifically to the current proposal as published for public comment, we may also support modifications that would improve the proposal. For example, other commenters or Commission staff may be able to identify and suggest further enhancements to the proposed definitions.

## **II. Analysis**

The Exchange Act requires that the rules of a national securities exchange be designed, in relevant part, to: prevent fraudulent and manipulative acts and practices; promote just and equitable principles of trade; foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions

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<sup>6</sup> 17 C.F.R. 200.30-3(a)(12); *see also* 15 U.S.C. § 78s(b)(2).

in securities; remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, protect investors and the public interest.<sup>7</sup> In our view, the proposed rules easily satisfy these fundamental requirements because they are designed to stop manipulative trading activity, including disruptive quoting and trading activity containing many of the elements indicative of spoofing<sup>8</sup> and layering.<sup>9</sup> Even if limited to a small number of cases, such disruptive quoting and trading behavior can cause significant harm to investors and the markets. For example, when traders use non-*bona fide* displayed orders to artificially and temporarily lifting the price of stocks, especially in small- and mid-cap stocks, legitimate orders of retail and institutional investors in the market during that time may suffer harm by having trades executed at the artificially inflated price. And on a larger scale, the Commodity Futures Trading Commission (“CFTC”) has suggested that spoofing may have contributed to the market conditions that led to the May 6, 2010 Flash Crash.<sup>10</sup> Ultimately, these types of practices can erode the public’s confidence in fair and orderly markets.

We would welcome and encourage the development of policies and practices designed to prevent or discourage disruptive and manipulative trading from occurring in the first place. We

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<sup>7</sup> See 15 U.S.C. § 78f(b)(5).

<sup>8</sup> As described in the Notice, the Exchange describes “spoofing” as a form of market manipulation that involves the market manipulator placing non-*bona fide* orders with the intention of cancelling those orders once they have triggered some type of market movement and/or response from other market participants, from which the market manipulator might benefit by trading *bona fide* orders.

<sup>9</sup> As described in the Notice, the Exchange describes “layering” as a form of market manipulation in which multiple, non-*bona fide* limit orders are entered on one side of the market at various price levels in order to create the appearance of a change in the levels of supply and demand, thereby artificially moving the price of the security. An order is then executed on the opposite side of the market at the artificially created price, and the non-*bona fide* orders are immediately cancelled.

<sup>10</sup> See Press Release, *CFTC Charges U.K. Resident Navinder Singh Sarao and His Company Nav Sarao Futures Limited PLC with Price Manipulation and Spoofing*, April 21, 2015 (“The CFTC Complaint Alleges that Defendants’ Manipulative Conduct Contributed to the Market Conditions that Led to the May 6, 2010 Flash Crash”), available at <http://www.cftc.gov/PressRoom/PressReleases/pr7156-15>.

recognize, however, that bad actors may always find ways to engage in manipulative behavior in the securities market. In light of that reality, the next best alternative is to expeditiously terminate manipulators' access to the market once the behavior is identified.

Whenever a U.S.-based broker-dealer permits a significant volume of manipulative trading to pass through its systems on a regular basis without establishing a supervisory system reasonably designed to detect and prevent this activity, the broker-dealer should be subject to the disciplinary process. To be effective, however, the disciplinary proceeding against the broker-dealer must be timely.

Based on the experiences described by the Exchange, it appears that cutting off the access points for such manipulative behavior can take an unacceptable length of time under the Exchange's current disciplinary process. As described in the Notice, in one case, the manipulative patterns were identified in 2007 and 2008, but the enforcement action to bar the violating firm from accessing the market was not concluded until 2012. In another case recounted in the Notice, the manipulative patterns were identified in 2009, yet the matter was not settled until 2012. In both cases, although the Exchange's surveillance detected the disruptive and manipulative quoting and trading promptly, the underlying manipulator continued to have sufficient access to the securities market for several years to continue its manipulative behavior while the Exchange's disciplinary process ran its course. This delay between the discovery of the manipulative behavior and its cessation is unacceptable.

We hope that the adoption of the Exchange's rule will help to obviate the need for its application. The proposed expedited process rule should act as a deterrent to U.S. broker-dealers that would otherwise permit manipulators to continue to access U.S. markets during the course of

an enforcement proceeding. Under expedited suspension procedures, such U.S. broker-dealers will no longer have an expectation of a lengthy period in which to continue to receive revenue through facilitating the trading activity of manipulative clients.

The Exchange's proposal appears to be appropriately tailored to minimize the possibility that it would curtail legitimate trading activities by market makers and other liquidity providers. Moreover, to the extent the Exchange's allegations are not ultimately borne out, the Exchange's expedited review process appears to provide appropriate safeguards for innocent parties, including adequate notice,<sup>11</sup> an opportunity to be heard at a meaningful time prior to the decision,<sup>12</sup> a right to appeal the determination,<sup>13</sup> and a right to obtain Commission review.<sup>14</sup>

We hope this proposal by BATS is the first step toward an industry-wide effort to combat these types of abusive practices. An expedited process that suspends a trader's ability to engage in manipulative trading activity on BATS would not be as effective if the trader were able to simply redirect the entire volume of manipulative trades to other market centers. We encourage all exchanges to review their procedures related to disruptive quoting and trading activity containing elements indicative of spoofing and layering, as the facts suggest the manipulative behavior may be a market-wide problem.

### **III. Conclusion**

In conclusion, we urge the Commission to approve the proposal. We commend the Exchange for its leadership in crafting a proposal to quickly address obvious disruptive and

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<sup>11</sup> See Proposed BATS Rule 8.17(a)(2)-(3).

<sup>12</sup> See Proposed BATS Rule 8.17(c).

<sup>13</sup> See Proposed BATS Rule 8.17(e).

<sup>14</sup> See Proposed BATS Rule 8.17(f).

manipulative behavior that would otherwise expose investors to significant and ongoing potential harm, and we would welcome similar efforts by other SROs, including the three other exchanges operated by BATS Global Markets, Inc., to expedite their regulatory processes when clear evidence of manipulative trading is identified.