

January 3, 2017

Self-Regulatory Organizations; Bats EDGX Exchange, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, Related to the Exchange's Equity Options Platform to Adopt a Price Improvement Auction, the Bats Auction Mechanism

I. Introduction

On September 16, 2016, Bats EDGX Exchange, Inc. (the "Exchange" or "EDGX") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change for the Exchange's equity options platform ("EDGX Options") to adopt a price improvement auction, the Bats Auction Mechanism. The proposed rule change was published for comment in the Federal Register on October 5, 2016.<sup>3</sup> The Commission received no comments regarding the proposal. On November 17, 2016, the Commission extended the time period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change.<sup>4</sup> On December 15, 2016, EDGX filed Amendment No. 1 to the proposal.<sup>5</sup> The Commission is

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 78988 (September 29, 2016), 81 FR 69172.

<sup>4</sup> See Securities Exchange Act Release No. 79339, 81 FR 84625 (November 23, 2016).

<sup>5</sup> In Amendment No. 1, EDGX provided additional details to its proposal and made certain changes to original aspects of the proposal. Specifically, the proposal as revised would: (i) restrict an Auction from commencing with a stop price equal to a same side resting order unless the resting order is not a Priority Customer order, the Exchange's "Customer Overlay" is in effect, and the incoming Agency Order is a Priority Customer order; (ii) prohibit an Initiating Order from being a solicited order for the account of an Options Market Maker assigned in the affected series on the Exchange; (iii) describe a survey conducted by the Exchange regarding the ability of participants to respond to an Auction

publishing this notice to solicit comment on Amendment No. 1 from interested persons and is approving the proposed rule change, as modified by Amendment No. 1, on an accelerated basis, with certain provisions subject to a pilot period scheduled to expire on January 18, 2017.

## II. Description of the Proposal, as Amended

EDGX proposes to establish a price-improvement auction, the Bats Auction Mechanism (“BAM,” “BAM Auction,” or “Auction”) on the Exchange’s equity options platform, in which an Exchange Member (an “Initiating Member”) may electronically submit for execution a two-sided paired order, where one side is an order it represents as agent on behalf of a Priority Customer,<sup>6</sup> broker-dealer, or any other person or entity (“Agency Order”) and the other side is principal interest or any other order it represents as agent (an “Initiating Order”) provided that the Member first exposes the Agency Order in the BAM Auction pursuant to the proposed Rule.

### A. Auction Eligibility Requirements

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lasting no less than one hundred milliseconds and no more than one second; (iv) provide additional explanation and justification of certain aspects of the proposal, including additional examples describing Auction processing and order allocation in various scenarios and details regarding the handling of overlapping Auctions for 50 contracts or more; and (v) make other minor structural, technical, and clarifying amendments to the proposal and the proposed rule text that EDGX believes does not result in any material differences over its original proposal. Amendment No. 1 amends and replaces the original filing in its entirety. To promote transparency of its proposed amendment, when EDGX filed Amendment No. 1 with the Commission, it also submitted a comment letter to the file with a brief description of Amendment No. 1, which the Commission posted on its website and placed in the public comment file for SR-BatsEDGX-2016-41. The Exchange also posted a copy of its Amendment No. 1 on its website when it filed the amendment with the Commission.

<sup>6</sup> A “Priority Customer” means any person or entity that is not: (A) a broker or dealer in securities; or (B) a Professional. The term “Priority Customer Order” means an order for the account of a Priority Customer. See EDGX Rule 16.1(a)(45). A “Professional” is any person or entity that: (A) is not a broker or dealer in securities; and (B) places more than 390 orders in listed options per day on average during a calendar month for its own beneficial account(s). All Professional orders shall be appropriately marked by Options Members. See EDGX Rule 16.1(a)(46).

All options traded on the Exchange are eligible for BAM.<sup>7</sup> To initiate a BAM Auction, an Initiating Member first must “stop” the Agency Order such that: (A) if the Agency Order is for less than 50 option contracts and the difference between the National Best Bid and Offer (“NBBO”) is \$0.01, the Initiating Member must stop the entire Agency Order at one minimum price improvement increment better than the NBBO; or (B) for any other Agency Order, the Initiating Member must stop the entire Agency Order at the better of the NBBO or the Agency Order’s limit price. In addition, if the EDGX BBO on the same side of the market as the Agency Order represents a Priority Customer order on the book, the stop price must be at least \$0.01 better than the booked order’s limit price. If the EDGX BBO on the same side of the market as the Agency Order represents a quote or order that is not a Priority Customer order on the book, the stop price must be at least \$0.01 better than the booked order’s limit price unless the Agency Order is a Priority Customer order and the Customer Overlay set forth in Rule 21.8(d)(1) is in effect.<sup>8</sup> In addition, Auctions in the same series of Agency Orders for less than 50 contracts may not queue or overlap in any manner; however, Auctions of Agency Orders for 50 contracts or more will be allowed to occur at the same time as other Auctions (of any size Agency Order) in the same series.<sup>9</sup> Finally, an Agency Order may not be a solicited order for the account of any

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<sup>7</sup> See proposed EDGX Rule 21.19(a).

<sup>8</sup> According to the Exchange, this condition is consistent with the operation of the Exchange generally, where Priority Customer orders receive a priority advantage over all other orders. See Amendment No. 1, *supra* note 5. See also EDGX Rule 21.8(d)(1), which specifies that when the Customer Overlay is in effect, Priority Customer Orders shall have priority over orders on behalf of all other types of participants (“non-Customers”) at the same price. The Exchange noted that the Customer Overlay is currently in effect with respect to all options traded on the Exchange. See Amendment No. 1, *supra* note 5.

<sup>9</sup> In its proposal, the Exchange notes that although it is possible for one or more Auctions for 50 contracts or more to overlap, each Auction will be started in a sequence and will have a distinct conclusion at which time the Auction will be allocated. Therefore, when the first Auction concludes, unrelated orders that then exist will be considered for

Options Market Maker assigned in the affected series.<sup>10</sup> Agency Orders that do not comply with the aforementioned auction eligibility requirements will be rejected. In addition, Agency Orders submitted at or before the opening of trading or when the NBBO is crossed are not eligible to initiate an Auction and will be rejected.

B. Auction Process

To initiate the Auction, the Initiating Member must mark the Agency Order for Auction processing, and specify either: (A) a single price at which it seeks to execute the Agency Order (a “single-price submission”); (B) that it is willing to automatically match as principal or as agent on behalf of an Initiating Order the price and size of all BAM Auction Notification responses (“BAM responses”) and other trading interest (“auto-match”) as follows: (i) stopping the entire order at a single stop price and auto-matching BAM responses and other trading interest at all prices that improve the stop price to a specified price; or (ii) stopping the entire order at a single stop price and auto-matching all BAM responses and other trading interest at all prices that improve the stop price. Once the Initiating Member has submitted an Agency Order for exposure in the Auction, such Agency Order may not be modified or cancelled.

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participation in that Auction. If there is remaining unrelated order interest after the first Auction has been allocated, then such unrelated order interest will be considered for allocation when the subsequent Auction is processed. If there are multiple Auctions underway that are each terminated early pursuant to proposed EDGX Rule 21.19(b)(2)(B) or (C), the Auctions will be processed sequentially based on the order in which they commenced. See Notice, supra note 3, at 69178-79 and Amendment No. 1, supra note 5. See also proposed EDGX Rule 21.19(b)(3) and proposed Interpretation and Policy .04 to EDGX Rule 21.19. In addition, each BAM response must specifically identify the Auction for which it is targeted and will only be considered in the specified Auction. See Notice, supra note 3, at 69179 and Amendment No. 1, supra note 5. See also proposed EDGX Rule 21.19(b)(1)(E).

<sup>10</sup> See proposed EDGX Rule 21.19(a)(6). The Exchange stated that this prohibition is based on a prohibition contained in other options exchanges’ auction mechanisms. See Amendment No. 1, supra note 5. See also Chapter VI, Section 9(i)(F) of the NASDAQ BX, Inc. (“BX”) Rules.

Under no circumstances will the Initiating Member receive an allocation percentage, at the final price point, of more than 50% of the initial Agency Order in the event there is one competing quote, order, or BAM response or 40% of the initial Agency Order in the event there are multiple competing quotes, orders, or BAM responses.<sup>11</sup> However, when starting an Auction, the Initiating Member may submit the Agency Order with a designation of “last priority” to other BAM participants (“Last Priority”), which will result in the Initiating Member forfeiting priority and trade allocation privileges. If Last Priority is specified, the Initiating Order would trade only if there were not enough interest available to fully execute the Agency Order at prices which are equal to or improve upon the stop price.<sup>12</sup> Last Priority information would not be available to other market participants and may not be modified after the order is submitted to the Auction.

When the Exchange receives an Agency Order for Auction processing, an auction notification message detailing the side, size, price, and options series of the Agency Order would be sent over the Exchange’s Multicast PITCH Feed and Auction Feed. BAM Auctions would be for a specified duration of no less than one hundred milliseconds and no more than one second, as determined by the Exchange and announced on the Exchange’s website.<sup>13</sup> Any person or

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<sup>11</sup> See proposed EDGX Rule 21.19(b)(1)(A).

<sup>12</sup> Last Priority will not be permitted if both the Initiating Order and Agency Order are Priority Customer Orders. See proposed EDGX Rule 21.19(b)(1)(B)(ii). In addition, Last Priority is only compatible with single-price submissions and cannot be designated on an Agency Order specified as auto-match. See proposed EDGX Rule 21.19(b)(1)(B)(iii).

<sup>13</sup> The Exchange states that, in September 2016, it conducted a survey of active EDGX market maker firms and other active liquidity providers inquiring as to the timeframe within which these market participants can respond to an auction with a duration time ranging from less than fifty (50) milliseconds to more than one (1) second. Of the ten (10) active EDGX market maker firms that were surveyed, eight (8) responded to the survey. In addition, the Exchange included six (6) additional liquidity providers that are not active EDGX market makers but are active participants on EDGX Options. Of the

entity other than the Initiating Member may submit a response to the Auction, provided such response is properly marked specifying price, size, side of the market, and information identifying the Auction to which the response is targeted. BAM responses would not be visible to Auction participants, and would not be disseminated to OPRA. The minimum price increment for BAM responses and for an Initiating Member's submission would be \$0.01, regardless if the class trades in another increment.<sup>14</sup>

A BAM response with a size greater than the size of the Agency Order will be capped at the size of the Agency Order (i.e., the excess size will be ignored when processing the Auction). BAM responses may be modified or cancelled during the Auction. BAM responses on the same side of the market as the Agency Order or with a Time in Force of IOC or FOK are considered invalid and will be immediately cancelled.<sup>15</sup> Finally, multiple BAM responses from the same User may be submitted during the Auction. However, multiple orders at a particular price point submitted by a User in response to an Auction or resting on the EDGX Options Book will be aggregated together and will be capped at the size of the Agency Order (i.e., the excess size will be ignored when processing the Auction).<sup>16</sup> BAM responses cannot cross the price of the Initial

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survey respondents, 93% indicated that that their firm could respond to auctions with a duration time of at least 50 milliseconds, and 100% indicated that that their firm could respond to auctions with a duration time of at least 100 milliseconds. Based on the results of the survey, the Exchange believes that allowing for an auction period of no less than one hundred (100) milliseconds and no more than one (1) second would provide a meaningful opportunity for Members to respond to the BAM Auction while at the same time facilitating the prompt execution of orders. The Exchange believes that 100 milliseconds will continue to provide all market participants with sufficient time to respond, compete, and provide price improvement for orders and will provide investors and other market participants with more timely executions, thereby reducing their market risk. See Amendment No. 1, supra note 5.

<sup>14</sup> See proposed EDGX Rule 21.19(b)(1)(G). See also Amendment No. 1, supra note 5.

<sup>15</sup> See proposed EDGX Rule 21.19(b)(1)(K). See also Amendment No. 1, supra note 5.

<sup>16</sup> See proposed EDGX Rule 21.19(b)(1)(I).

NBBO but will be executed, if possible, at the most aggressive permissible price within such Initial NBBO.

C. Conclusion of an Auction and Order Allocation

The BAM Auction would conclude at the earlier of: (i) the end of the Auction period; (ii) upon receipt by the Exchange of a Priority Customer order on the same side of the market and at the stop price of the Agency Order that is to be posted to the EDGX Options Book; (iii) upon receipt by the Exchange of an unrelated order or quote that is not a Priority Customer order that is on the same side of the market as the Agency Order that would cause the Agency Order's stop price to be outside of the EDGX BBO; (iv) at the close of trading; or (v) any time there is a trading halt on the Exchange in the affected series.<sup>17</sup>

If the BAM Auction concludes earlier than the end of the prescribed Auction period for any of the reasons described above other than a trading halt, the Auction will be processed pursuant to the order allocation process set forth in proposed EDGX Rule 21.19(b)(4).<sup>18</sup> In the event of a trading halt on the Exchange in the affected series, the Auction will be cancelled without execution.<sup>19</sup>

Any unexecuted BAM responses will be cancelled.<sup>20</sup> An unrelated market or marketable

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<sup>17</sup> See proposed EDGX Rule 21.19(b)(2). In Amendment No. 1, the Exchange stated that the proposed difference between scenario (ii), where an unrelated, same-side Priority Customer order will cause early termination of an Auction when it arrives on the Exchange at the stop price, and scenario (iii), where an unrelated, same-side order or quote from a non-Priority Customer will cause early termination of an Auction only when it would be better than the stop price, is consistent with the Exchange's belief that a Priority Customer order received and placed on the Exchange's order book should have certainty that it will be the first order executed at that price in response to contra-side liquidity. See Amendment No. 1, supra note 5.

<sup>18</sup> See proposed EDGX Rule 21.19(b)(2)(A)-(D).

<sup>19</sup> See proposed EDGX Rule 21.19(b)(2)(E).

<sup>20</sup> See proposed EDGX Rule 21.19(b)(5).

limit order (against the EDGX BBO) on the opposite side of the market from the Agency Order received during the Auction will not cause the Auction to end early and will execute against interest outside of the Auction.<sup>21</sup> If contracts remain from such unrelated order at the time the auction ends, they will be considered for participation in the order allocation process. All unrelated orders submitted to the Exchange with contracts remaining at the time the Auction ends, including orders marked as Post Only Orders pursuant to EDGX Rule 21.1(d)(8),<sup>22</sup> will be considered for participation in the order allocation process. If an Auction is initiated for an Agency Order designated as an “Intermarket Sweep Order” or “ISO” Order,<sup>23</sup> responses and executions will be permitted at a price inferior to the Initial NBBO.<sup>24</sup>

At the conclusion of the Auction, the Agency Order will be allocated at the best price(s), pursuant to the priority set forth in proposed EDGX Rule 21.19(b)(4).<sup>25</sup> First, Priority Customer orders would have time priority at each price level. Next, the Initiating Member would receive

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<sup>21</sup> See proposed EDGX Rule 21.19(b)(3).

<sup>22</sup> The Exchange noted that Post Only Orders would participate in an Auction in the same manner as any other unrelated order even if the Post Only Order would be considered to be removing liquidity from the Auction. See Amendment No. 1, supra note 5.

<sup>23</sup> “Intermarket Sweep Orders” or “ISO” Orders are limit orders that are designated as ISOs in the manner prescribed by EDGX and are executed within the System at one or multiple price levels without regard to Protected Quotations of other Eligible Exchanges as defined in EDGX Rule 27.1. ISOs are not eligible for routing pursuant to EDGX Rule 21.9. In Amendment No. 1, the Exchange described in greater detail how a BAM ISO would be handled if any better priced interest arrived on the Exchange’s order book after the BAM ISO was sent but before the corresponding Auction commenced. See Amendment No. 1, supra note 5 (stating that in this circumstance, any better priced interest in the order book at the time of such BAM Auction would be executed pursuant to the proposed Auction functionality).

<sup>24</sup> See proposed EDGX Rule 21.19(b)(6).

<sup>25</sup> See Notice, supra note 3, at 69176-78 and Amendment No. 1, supra note 5, for examples illustrating trade allocations under various auction scenarios.



an allocation after Priority Customer orders.<sup>26</sup>

If the Initiating Member selected the single-price submission option, BAM executions will occur first at prices that improve the stop price, and then at the stop price with up to 40% of the remaining contracts after Priority Customer interest is satisfied being allocated to the Initiating Member at the stop price. However, if only one other quote, order, or BAM response matches the stop price, the Initiating Member may be allocated up to 50% of the contracts executed at such price.

If the Initiating Member selected the auto-match option, the Initiating Member would be allocated a number of contracts equal to the aggregate size of all other quotes, orders, and BAM responses at each price point until a price point is reached where the balance of the order can be fully executed, except that the Initiating Member would be entitled to receive up to 40% (if there are multiple competing quotes, orders, or BAM responses) or 50% (if there is only one competing quote, order, or BAM response) of the initial Agency Order at the final price point (including situations where the stop price is the final price), after Priority Customer interest has been satisfied but before remaining interest receives an allocation.

After Public Customers and the Initiating Participant receive their allocations, and for classes designated by the Exchange as eligible for “Priority Order” status, Users with resting quotes and orders that were at a price that is equal to the Initial NBBO on the opposite side of the market from the Agency Order (“Priority Orders”) would have priority up to their size in the Initial NBBO at each price level at or better than such Initial NBBO. Priority Orders and BAM responses submitted by Users with Priority Order Status will be allocated pursuant to the

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<sup>26</sup> The Initiating Participant shall receive additional allocation only if contracts remain after any allocation pursuant to proposed EDGX Rule 21.19(b)(4).

algorithm set forth in EDGX Rule 21.8(c).<sup>27</sup>

Finally, after Priority Customers, the Initiating Member, and Users with Priority Orders, if applicable, have received allocations, all other interest will be allocated pursuant to Rule 21.8(c).<sup>28</sup> Any remaining contracts will be allocated to the Initiating Member.

D. Crossing Agency Orders

The Exchange also proposes, in lieu of the BAM Auction procedures set forth in proposed paragraphs (a) – (b) to EDGX Rule 21.19, to allow an Initiating Member to enter an Agency Order for the account of a Priority Customer paired with an order for the account of another Priority Customer, and such paired orders will be automatically executed without an Auction. In its proposal, the Exchange notes that it would be a violation of EDGX Rule 22.12 for an Options Member to circumvent EDGX Rule 22.12 by providing an opportunity for (i) a Priority Customer affiliated with the Options Member, or (ii) a Priority Customer with whom the Options Member has an arrangement that allows the Options Member to realize similar economic benefits from the transaction as the Options Member would achieve by executing agency orders as principal, to regularly execute against agency orders handled by the firm immediately upon their entry as BAM Priority Customer-to-Priority Customer immediate crosses.<sup>29</sup>

E. Pilot Program Information to the Commission

Subject to a pilot program expiring January 18, 2017,<sup>30</sup> there will be no minimum size

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<sup>27</sup> See proposed EDGX Rule 21.19(b)(4)(B)(iii). Priority Order status is only valid for the duration of the particular Auction.

<sup>28</sup> See proposed EDGX Rule 21.19(b)(4)(B)(iv).

<sup>29</sup> See Notice, supra note 3, at 69176. See also Amendment No. 1, supra note 5 and proposed Interpretation and Policy .03 to EDGX Rule 21.19.

<sup>30</sup> See proposed Interpretation and Policy .05 to EDGX Rule 21.19.

requirement for orders to be eligible for the Auction. During this pilot period, the Exchange represents that it periodically will submit certain data, as requested by the Commission staff, to provide supporting evidence that, among other things, there is meaningful competition in BAM Auctions for all size orders and that there is an active and liquid market functioning on the Exchange outside of the Auction mechanism.<sup>31</sup> The Exchange further noted that it would seek to request confidential treatment for any raw data that it submits to the Commission.<sup>32</sup>

The Exchange represented that it will provide the following additional information on a monthly basis:

- (i) The number of contracts (of orders of 50 contracts or greater) entered into BAM Auctions;
- (ii) The number of contracts (of orders of fewer than 50 contracts) entered into BAM Auctions;
- (iii) The number of orders of 50 contracts or greater entered into BAM Auctions; and
- (iv) The number of orders of fewer than 50 contracts entered into BAM Auctions.

### III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange and, in particular, with Section 6(b) of the Act.<sup>33</sup> In particular, the

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<sup>31</sup> See Notice, supra note 3, at 69176. See also Amendment No. 1, supra note 5.

<sup>32</sup> See Notice, supra note 3, at 69176; Amendment No. 1, supra note 5. See also proposed Interpretation and Policy .05 to EDGX Rule 21.19.

<sup>33</sup> 15 U.S.C. 78f(b). In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>34</sup> which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect customers, issuers, brokers and dealers. The Commission believes that the Exchange's proposal to establish the BAM may increase competition among those options exchanges that offer similar price improvement mechanisms. The Commission further believes that allowing EDGX Members to enter orders into the BAM will provide additional opportunities for such orders to receive price improvement over the NBBO and, in some instances, will result in such orders receiving price improvement over the NBBO.

In particular, the Commission notes that, in order to initiate an Auction, the Initiating Member must stop the entire Agency Order as principal or with a solicited order at a price in an increment of \$0.01 such that if the Agency Order is for less than 50 option contracts and the difference between the NBB and NBO is \$0.01, the Initiating Member must stop the entire Agency Order at one minimum price improvement increment better than the NBBO, which increment shall be determined by the Exchange but may not be smaller than \$0.01. The Commission believes that guaranteed price improvement for Agency Orders of fewer than 50 contracts when the difference between the NBB and NBO is \$0.01 will benefit such Agency Orders. The Commission notes further that, for any other Agency Order, the Initiating Member must stop the entire Agency Order

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<sup>34</sup> 15 U.S.C. 78f(b)(5).

at the better of the NBBO or the Agency Order's limit price (if the order is a limit order).

Accordingly, the proposed rule change will provide customers with an opportunity for price improvement over the NBBO in those instances.

If the EDGX BBO on the same side of the market as the Agency Order represents a Priority Customer order on the book, the stop price must be at least \$0.01 better than the booked order's limit price. If the EDGX BBO on the same side of the market as the Agency Order represents a quote or order that is not a Priority Customer order on the book, the stop price must be at least \$0.01 better than the booked order's limit price unless the Agency Order is a Priority Customer order and the Customer Overlay set forth in Exchange Rule 21.8(d)(1) is in effect. The Commission notes that the Exchange has represented that this condition is consistent with the operation of the Exchange generally, where the Customer Overlay is currently in effect with respect to all options traded on the Exchange, and Priority Customer Orders have first priority over other orders at the same price.

With respect to Agency Orders for less than 50 contracts, only one BAM Auction may be ongoing at any given time in a series and Auctions in the same series may not queue or overlap in any manner. However, BAM Auctions for Agency Orders of 50 contracts or more will be allowed to occur at the same time as other Auctions in the same series. The Commission notes that the BAM rules regarding the processing of overlapping BAM Auctions for Agency Orders of 50 contracts or more have been made transparent in the proposed rule change and are reasonable, given that the electronic nature of BAM makes the sequence of auction start times readily discernable.<sup>35</sup> In particular, the Commission notes that a BAM response will only be considered for its specified Auction. Each BAM response must specifically identify the BAM Auction for

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<sup>35</sup> See proposed Interpretation and Policy .04 to EDGX Rule 21.19.

which it is targeted, and if not fully executed, the BAM response will be cancelled back at the conclusion of the auction.

All BAM Auctions will last for a period of no less than 100 milliseconds and no more than one second, as determined by the Exchange and announced on the Exchange's website. As the Exchange discussed in its proposal, the Exchange conducted a survey of active EDGX market maker firms and other active liquidity providers inquiring as to the timeframe within which these market participants respond to an auction with a duration time ranging from less than fifty (50) milliseconds to more than one (1) second. According to the Exchange, a majority of the market maker firms and active liquidity providers on EDGX Options that responded to the survey indicated that they were capable of responding to auctions with a duration time of at least 50 milliseconds.<sup>36</sup> Based on the Exchange's statements, the Commission believes that the proposed duration of the BAM Auction could facilitate the prompt execution of orders in the BAM, while providing market participants with an opportunity to compete for exposed bids and offers. The Commission notes that other exchanges' price improvement auctions provide for auction response periods within the range of the response duration proposed by EDGX.<sup>37</sup>

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<sup>36</sup> Of the ten (10) active EDGX market maker firms that were surveyed, eight (8) of these market makers responded to the survey. In addition, because EDGX is a relatively new options exchange and is still encouraging market makers to register and participate on the Exchange as such, and to increase the sample size, the Exchange included six (6) additional liquidity providers that are not active EDGX market makers but are active participants on EDGX Options. Thirteen (13) of the fourteen (14) respondents, or 93% indicated that their firm could respond to auctions with a duration time of at least 50 milliseconds, though one of these firms indicated a preference of auctions with a duration of 100 milliseconds. The remaining firm indicated that it could respond to auctions with a duration of at least 100 milliseconds. This survey was conducted in September of 2016.

<sup>37</sup> See Chapter VI, Section 9(ii)(A)(3) of the BX Rules (auction period between 100 milliseconds and 1 second), International Securities Exchange, LLC ("ISE") Rule 723(c)(5) (auction period of 500 milliseconds), CBOE Rule 6.74A(b)(1)(C) (auction period of 1 second), and BOX Options Exchange LLC ("BOX") Rule 7150(f)(1) (auction period of 100 milliseconds).

The Commission believes that the Exchange's proposed matching algorithm is sufficiently clear regarding how orders are to be allocated in the BAM Auction and is designed in a manner that should facilitate a competitive auction process. The Commission further believes that permitting Priority Orders to have enhanced priority may encourage EDGX Users to quote aggressively with additional size outside of the BAM Auction and, therefore, may enhance competition and liquidity on the EDGX market.

Under the proposal, the BAM Auction would be available for orders of fewer than 50 contracts. There would be no minimum size requirement for orders entered into the BAM Auction for a pilot period expiring on January 18, 2017. The Exchange has represented its commitment to submit certain data on BAM Auctions at the request of Commission staff. The Commission expects such data to be used, by both the Exchange and the Commission staff, to assess the performance of the BAM Auction, including, among other things, to study whether there is meaningful competition for all size orders with the BAM, the degree of price improvement for all orders executed through the BAM, and whether there is an active and liquid market functioning on the Exchange outside of the BAM. The data provided will enable the Commission, as well as the Exchange itself, to evaluate the BAM Auction to determine its performance and possible impact on EDGX and options market structure in general and the degree to which it is beneficial to customers and to the options market as a whole.

#### IV. Section 11(a) of the Act

Section 11(a)(1) of the Act<sup>38</sup> prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises investment discretion (collectively,

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<sup>38</sup> 15 U.S.C. 78k(a)(1).

“covered accounts”) unless an exception applies. Rule 11a2-2(T) under the Act,<sup>39</sup> known as the “effect versus execute” rule, provides exchange members with an exemption from the Section 11(a)(1) prohibition. Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute transactions on the exchange. To comply with Rule 11a2-2(T)’s conditions, a member: (i) must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;<sup>40</sup> (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member or an associated person has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the Rule. For the reasons set forth below, the Commission believes that Exchange members entering orders into the BAM Auction would satisfy the requirements of Rule 11a2-2(T).

The Rule’s first condition is that orders for covered accounts be transmitted from off the exchange floor. In the context of automated trading systems, the Commission has found that the off-floor transmission requirement is met if a covered account order is transmitted from a remote location directly to an exchange’s floor by electronic means.<sup>41</sup> EDGX represents that the EDGX

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<sup>39</sup> 17 CFR 240.11a2-2(T).

<sup>40</sup> This prohibition also applies to associated persons. The member may, however, participate in clearing and settling the transaction.

<sup>41</sup> See, e.g., Securities Exchange Act Release Nos. 61419 (January 26, 2010), 75 FR 5157 (February 1, 2010) (SR-BATS-2009-031) (approving BATS options trading); 59154 (December 23, 2008), 73 FR 80468 (December 31, 2008) (SR-BSE-2008-48) (approving equity securities listing and trading on BSE); 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008) (SR-NASDAQ-2007-004 and SR-NASDAQ-2007-080) (approving NOM options trading); 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131) (approving The Nasdaq Stock Market LLC); 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (SR-PCX-00-25) (approving Archipelago Exchange);



trading system and the proposed BAM Auction receive all orders electronically through remote terminals or computer-to-computer interfaces.<sup>42</sup> The Exchange also represents that orders for covered accounts from Members will be transmitted from a remote location directly to the proposed BAM mechanism by electronic means. Because no Exchange members may submit orders into the BAM Auction from on the floor of the Exchange, the Commission believes that the BAM Auction satisfies the off-floor transmission requirement.

Second, the Rule requires that the member and any associated person not participate in the execution of its order after the order has been transmitted. The Exchange represents that at no time following the submission of an order is a Member able to acquire control or influence over the result or timing of the order's execution.<sup>43</sup> According to the Exchange, the execution of an order sent to the BAM mechanism is determined by what other orders are present and the priority of those orders.<sup>44</sup> Accordingly, the Commission believes that a member does not participate in the execution of an order submitted to the BAM mechanism.

Third, Rule 11a2-2(T) requires that the order be executed by an exchange member who is unaffiliated with the member initiating the order. The Commission has stated that this

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29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (SR-NYSE-90-52 and SR-NYSE-90-53) (approving NYSE's Off-Hours Trading Facility); and 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) ("1979 Release").

<sup>42</sup> See Notice, supra note 3, at 69179-80. See also Amendment No. 1, supra note 5.

<sup>43</sup> See Notice, supra note 3, at 69180. See also Amendment No. 1, supra note 5 (also representing, among other things, that: 1) no Member, including the Initiating Member, will see a BAM response submitted into BAM and therefore will not be able to influence or guide the execution of their Agency Orders, 2) the Last Priority feature will not permit a Member to have any control over an order, and the election to Last Priority an order is available prior to the submission of the order, will not be broadcast and further, the Last Priority option may not be modified by the Initiating Member during the auction).

<sup>44</sup> See Notice, supra note 3, at 69180. See also Amendment No. 1, supra note 5. The Exchange notes that a Member may not cancel or modify an order after it has been submitted into BAM.

requirement is satisfied when automated exchange facilities, such as the BAM mechanism, are used, as long as the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange.<sup>45</sup>

EDGX represents that the BAM Auction is designed so that no Member has any special or unique trading advantage in the handling of its orders after transmitting its orders to the mechanism.<sup>46</sup> Based on the Exchange's representation, the Commission believes that the BAM mechanism satisfies this requirement.

Fourth, in the case of a transaction effected for an account with respect to which the initiating member or an associated person thereof exercises investment discretion, neither the initiating member nor any associated person thereof may retain any compensation in connection with effecting the transaction, unless the person authorized to transact business for the account has expressly provided otherwise by written contract referring to Section 11(a) of the Act and Rule 11a2-2(T) thereunder.<sup>47</sup> EDGX represents that Members relying on Rule 11a2-2(T) for

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<sup>45</sup> In considering the operation of automated execution systems operated by an exchange, the Commission noted that, while there is not an independent executing exchange member, the execution of an order is automatic once it has been transmitted into the system. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See 1979 Release, supra note 41.

<sup>46</sup> See Notice, supra note 3, at 69180. See also Amendment No. 1, supra note 5.

<sup>47</sup> In addition, Rule 11a2-2(T)(d) requires a member or associated person authorized by written contract to retain compensation, in connection with effecting transactions for covered accounts over which such member or associated persons thereof exercises investment discretion, to furnish at least annually to the person authorized to transact business for the account a statement setting forth the total amount of compensation retained by the member or any associated person thereof in connection with effecting transactions for the account during the period covered by the statement. See 17 CFR 240.11a2-2(T)(d). See also Securities Exchange Act Release No. 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978) (stating “[t]he contractual and disclosure requirements are designed to assure that accounts electing to permit transaction-related

transactions effected through the BAM Auction must comply with this condition of the Rule and that the Exchange will enforce this requirement pursuant to its obligations under Section 6(b)(1) of the Act to enforce compliance with federal securities laws.<sup>48</sup>

V. Accelerated Approval of Proposal, as Modified by Amendment No. 1

The Commission finds good cause, pursuant to Section 19(b)(2) of the Exchange Act, to approve the proposal, as modified by Amendment No. 1, prior to the 30th day after publication of Amendment No. 1 in the Federal Register. In Amendment No. 1, EDGX revised the original proposal to make the changes discussed in detail above. Notably, in Amendment No. 1, EDGX revises its proposal to restrict an Auction from commencing with a stop price equal to a same side resting order except in limited circumstances, as described above, and prohibit an Initiating Order from being a solicited order for the account of an Options Market Maker assigned in the affected series on the Exchange. EDGX also made changes to clarify and add detail to its proposal and the proposed rule text. The Commission believes that Amendment No. 1 does not raise any novel regulatory issues and instead better aligns EDGX's proposed Auction functionality with existing functionality on the Exchange and with that of similar auction mechanisms operated by other options exchanges, and provides additional clarity in the rule text, which is consistent with EDGX's original proposal and supports EDGX's analysis of how its proposal is consistent with the Act, thus facilitating the Commission's ability to make the findings set forth above to approve the proposal. Accordingly, the Commission finds that good cause exists to approve the proposal, as modified by Amendment No. 1, on an

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compensation do so only after deciding that such arrangements are suitable to their interests").

<sup>48</sup> See Notice, supra note 3, at 69180. See also Amendment No. 1, supra note 5.

accelerated basis.

## VI. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment No. 1 is consistent with the Act. Comments may be submitted by any of the following methods:

### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-BatsEDGX-2016-41 on the subject line.

### Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-BatsEDGX-2016-41. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>).

Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549-1090, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the

principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-BatsEDGX-2016-41 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>49</sup> that the proposed rule change (SR-BatsEDGX-2016-41), as modified by Amendment No. 1, be and hereby is approved on an accelerated basis, except that there shall be no minimum size requirement for orders to be eligible for the Auction for a pilot period expiring on January 18, 2017.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>50</sup>

Eduardo A. Aleman  
Assistant Secretary

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<sup>49</sup> 15 U.S.C. 78s(b)(2).

<sup>50</sup> 17 CFR 200.30-3(a)(12).