SEC Charges Direct Edge Exchanges With Failing to Properly Describe Order Types

Washington D.C., Jan. 12, 2015 —

The Securities and Exchange Commission today announced that two exchanges formerly owned by Direct Edge Holdings and since acquired by BATS Global Markets have agreed to pay a $14 million penalty to settle charges that their rules failed to accurately describe the order types being used on the exchanges. The penalty is the SEC's largest against a national securities exchange, and the case is the SEC's first principally focusing on stock exchange order types.

An SEC investigation found that while operating under rules that described a single "price sliding" process for handling buy or sell orders, the EDGA Exchange and EDGX Exchange actually offered three variations of "price sliding" order types. The exchanges' rules did not completely and accurately describe the prices at which those orders would be ranked and executable in certain circumstances, and they also failed to describe the execution priority of the three order types relative to each other and other order types. The SEC's investigation further found that the exchanges separately disclosed information about how those order types operated to some but not all of their members.

"These exchanges did not properly describe in their rules how their order types were functioning," said Andrew J. Ceresney, Director of the SEC's Division of Enforcement. "They also gave information about order types only to some members, including certain high-frequency trading firms that provided input about how the orders would operate. Exchanges must ensure that their order types are described accurately in their rules and communications to all members."

According to the SEC's order instituting a settled administrative proceeding, exchanges and other self-regulatory organizations are required under federal securities laws to obtain Commission approval for rules governing order types and operate in compliance with their own set of rules as approved by the SEC. An important category of an exchange's rules is the operation of its order types, so that its members and all other participants in trading on an exchange can understand the terms and conditions under which trading is conducted. From the time they began operating as registered exchanges in 2010 until late 2014, when they finally updated their rules and obtained Commission approval for the changes, the EDGA Exchange and EDGX Exchange were supposed to be processing orders using a single "displayed price sliding process" according to their rules. However, the exchanges actually offered three price sliding order types: Hide Not Slide, Price Adjust, and Single Re-Price. These were not completely and accurately described in their rules.

The SEC's order also finds that the exchanges provided complete and accurate information about the order types to only some members, including certain high-frequency trading firms that Direct Edge also solicited for input about how the Hide Not Slide order type should operate. Direct Edge originally developed this order type following a request from one of the firms. Although the exchanges provided information about the Hide Not Slide order type in technical specifications made available to all members, those technical specifications did not contain fully accurate information. This created a significant risk that not all market participants would understand how these order types operated.

The SEC's order finds that the EDGA and EDGX exchanges violated Sections 19(b) and 19(g) of the Securities Exchange Act of 1934. Without admitting or denying the SEC's findings, EDGA and EDGX agreed to accept a censure, pay the $14 million penalty, and cease and desist from committing these violations. EDGA and EDGX also agreed to comply with various undertakings, including a requirement that they develop new policies and procedures relating to the development of, rule filing process for, and communication of information regarding order types.

This is the SEC's second enforcement action against the Direct Edge exchanges. In October 2011, the Commission found that EDGA and EDGX violated Sections 19(b) and 19(g) of the Exchange Act and ordered remedial measures in connection with two systems incidents occurring in November 2010 and April 2011.

The SEC's investigation was conducted by Kathryn Pyszka, Fuad Rana, Darren Boerner, Ainsley Kerr, and Mandy Sturmfelz of the SEC's Market Abuse Unit as well as James Thibodeau of the Chicago Regional Office. The case was supervised by Daniel M. Hawke, Chief of the Market Abuse Unit, Stephen L. Cohen, Associate Director in the Washington D.C. office, Timothy L. Warren, Associate Regional Director in the Chicago office, and Robert A. Cohen and Joseph Sansone, Co-Deputy Chiefs of the Market Abuse Unit.