LEKSECURITIES

December 28, 2015

Comment by Lek Securities Corporation on BATS Exchange Inc. Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to Adopt Rule 8.17 to Provide a Process for an Expedited Suspension Proceeding and Rule 12.15 to Prohibit Disruptive Quoting and Trading Activity

Release No: SR-BATS-2015-101
SEC File Number: 34-76470

Lek Securities is pleased to comment on BATS Exchange's proposal, which is designed to prohibit disruptive quoting and trading activity on the Exchange. The proposal is substantively the same as a previous proposed rule by the Exchange, which was designed to prohibit Layering and Spoofing as defined in the proposed Rule[1]. This previously proposed rule was withdrawn on November 9, 2015[2].

The current rule is substantively the same as the proposal that was withdrawn. Instead of prohibiting "layering" and "spoofing" outright however, the current proposal seeks to prohibit "disruptive quoting and trading activity" and then references an interpretation in which this activity is defined in an identical fashion as the term "layering" and "spoofing" in the original withdrawn proposal. By moving the definition of the trading activity that the Exchange seeks to ban from the body of the rule to an interpretation, very little has changed and the currently proposed rule has all of the flaws of the original proposal.

Section 10b of the Act and Rule 10b-5 broadly prohibit manipulation, so the proposed rule is unnecessary. Moreover, the proposal is anti-competitive, hurts investors, illegally discriminates between customers, and thwarts competition. In addition, the proposal attempts to extend the Exchange's jurisdiction to orders placed on competing exchanges and to persons, who are not members of the Exchange. Specifically, the Rule would grant the Exchange the authority to order a member to cut off a client's trading without any ability for the client to be heard, under the threat of a bar from the industry of the member itself. This amounts to nothing less than a group boycott. Finally, the Exchange proposes that this draconian process should by-pass current due process requirements and be decided by a hearing panel in a summary proceeding without the time or opportunity for discovery.

The proposal is at odds with many provisions of the Securities and Exchange Act. The group boycott of non-member clients is at odds with the antitrust laws. For these reason, as elaborated upon in detail below, the Commission must reject this proposal in its entirety.

The BATS Exchange is a privately owned Exchange controlled by high frequency traders that seek to eliminate competition to their own advantage and at the expense of investors

[1] Release No: SR-BATS-2015-57 - SEC File Number: 34-75693
[2] Release No. 34-76393; File No. SR-BATS-2015-57

The Commission should be aware that BATS is owned and controlled by large high frequency trading firms ("HFTs") whose trading strategy is to front-run large institutional orders. What the Exchange is advocating is the ability for HFTs to detect institutional buying interest and to be able to front-run institutional orders risk free, i.e. they seek to buy stock ahead of the institution, bid up the price, and re-sell stock back to the institution at a higher level.

In a free market this strategy entails risk as the high-frequency trader does know for sure whether what is perceived to be institutional buying interest will follow through or cancel. They therefore seek regulatory protection and advocate rules that would eliminate trading strategies that add such risk to their front-running strategies. In order to protect the front-running they need rules that penalize traders that cancel orders that high-frequency trades seek utilize as free put options. If after the front-running the stock continues to rise, the front-runner sells at a profit. If however the stock goes down, the front-runner seeks to employ the Original Orders as a free put options. When the Original Orders cancel, they cry foul and complain of "manipulation".

The proposed rules benefit high frequency traders at the expense of institutional investors. Institutional investors, such as pension funds and insurance companies represent millions of American investors. These institutions regularly complain that when they try to buy stock the price is run up ahead of them. The Commission should protect American investors; not high frequency traders that seek to front-run their orders and seek regulatory protection for their strategies. Congress envisioned that the Act would perfect the mechanism of a free and open market. The risk that front-runners face that orders that are relied upon as free put options might cancel is an inherent risk of trading in a free market. Regulatory interference with this risk is unwarranted and would cost investors billions.

Disruptive Quoting and Trading Activity as defined in the interpretation of the proposed Rule are not manipulative and accordingly do not violate the anti-fraud provisions of the securities laws. The proposal is overbroad and seeks to prohibit unquestionably legitimate trading activity.

Although the proposal freely uses the words "fraudulent", "manipulative" and "disruptive" and claims "large" harm to investors, the Exchange does nothing to explain why the defined trading would cause any harm at all. Instead, the Exchange seems to believe that it can obviate this by pointing to a number of settlements in which the respondents neither admitted nor denied the allegations and by their terms specifically state that the cited facts cannot be used outside of the context of the settlements. Accordingly, the settlements prove nothing.

The Exchange grossly oversimplifies the ability to determine whether a series of orders and cancellations constitutes illegal market manipulation. Indeed, the Proposal's broad and subjective definitions of Disruptive Quoting and Trading Activity encompass strategies that consist of competitive trading algorithms that narrow spreads and add depth and liquidity to the market, thereby benefitting investors. Instead of protecting investors, as discussed below, the practical result of the Proposal is to vest the Exchange with the extraordinary power to eliminate risk from the front-running strategies of its high-frequency trading members and owners at the expense of investors under the guise of preventing manipulation.

Unlike the Exchange's assertion, manipulation is hard to prove. Generally courts have held that the alleged manipulator must inject false information into the market and that this must be done with scienter. Orders do not become manipulative merely because another trader reads more into them than what they are, such as speculating that there may be more un-displayed quantity “behind”, or that the orders will not cancel and thus can be used as a free stop-loss. Nor does it matter whether the person that entered the orders “hopes” that they will not be executed. A competing trader cannot claim to be a victim of manipulation if he makes speculative conclusions based on displayed actionable bids and offers and then speculates incorrectly.

We now analyze Disruptive Quoting and Trading Activity, as defined by the proposed Rule in the context of the provision of the Act. Specifically Section 6 requires that the rules of an exchange meet the following standards:

i. Prevent fraudulent and manipulative acts and practices;
ii. Promote just and equitable principles of trade;
iii. Foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities […];
iv. Remove impediments to and perfect the mechanism of a free and open market and a national market system;
v. Protect investors and the public interest.

The rules of an exchange may not:

i. Permit unfair discrimination between customers, issuers, brokers, or dealers;
ii. Regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the exchange;
iii. The rules of the exchange may not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this chapter.

For the purpose of the proposed Rule, “Disruptive Quoting and Trading Activity Type 1” is defined quoting and trading activity that includes a frequent pattern in which the following facts are present:

1. a party enters multiple limit orders on one side of the market at various price levels (the “Displayed Orders”); and
2. following the entry of the Displayed Orders, the level of supply and demand for the security changes; and
3. the party enters one or more orders on the opposite side of the market of the Displayed Orders (the “Contra-Side Orders”) that are subsequently executed; and
4. following the execution of the Contra-Side Orders, the party cancels the Displayed Orders.

As an initial matter, the Rule should specifically define the proscribed behavior; if it only *includes* the enumerated facts, the reader is left to guess what else might fall within the definition. This makes the Rule unacceptability vague. The same is true for the word “frequent“ and the word “pattern”. How often is “frequent” and what constitutes a “pattern”, is left up in the air, presumably to allow the Exchange staff to prosecute customers it does not like while at the same time protecting large high fee paying HFT members. The same holds true for the word “multiple”. How many orders is “multiple”? We have asked BATS’ regulatory personnel in the past to tell us how many orders are too many, but the staff has refused to tell us. This is unacceptable.

It is difficult to imagine what is wrong with step (1). People enter multiple orders on one side of the market all day long. In fact, this is typical of an algorithm that will spread its interest across a multitude of trading venues in order to cover as many markets as possible so as to be able to benefit from liquidity no matter where it shows up. There is nothing manipulative about entering multiple orders. As long as the orders are real, i.e. any person on the opposite of the market can trade with them, there is no false information and therefore nothing manipulative about these orders. In fact, any rule designed to prohibit entry of orders would appear to violate the Act's mandate sub (iv) as it would create (as opposed to remove) an impediment to, and obstruct (rather than perfect) the mechanism of a free and open market. Whether a trader hopes that his Displayed Orders will be executed, or hopes that they will not be executed, does not turn an otherwise legitimate order into a fraud. The Act envisions free markets where people can trade as they please and the market is established by unobstructed interaction of persons offering to buy and persons offering to sell.

The requirement step (2) of the definition of Disruptive Quoting and Trading Activity Type 1 appears entirely illogical: "Following the entry of the Displayed Orders, the level of supply *and* demand for the security changes". If a trader enters "buy" orders, the level of demand for the security will, of course, rise. If the trader enters "sell" orders, the level of supply will rise. But at this point in time the trader has only entered orders on one side of the market, so how can the level of both supply *and* demand change? Is it a requirement of the proposed definition that sellers in light of viewing a trader's "buy" orders cancel their sell orders? That would be a way of both supply and demand changing (demand up-supply down), but it would have the bizarre effect of making one person's violation a function of a possible action of an anonymous third party. Moreover, how should one measure the level of supply and demand? How does one measure the quantity? Does un-displayed quantity count, and how about quantity entered on other exchanges or in dark pools where no one knows the level of supply and demand? How can that impact of one trader's actions possibly be isolated with any degree of certainty? Moreover, why is a change in supply and demand proof of manipulation, especially as that analysis may be able to be done for virtually every order? The provision makes no practical sense.

Next, under step (3) the trader enters an order on the other side of the market. There is nothing false or misleading about that order either, because a further requirement of the violation is that the order is executed, proving that it was real. There is no false information, and therefore no manipulation. Moreover, for the order to get executed, it must have improved the NBBO, meaning that the trader was willing to pay a higher price (or sell at a lower price) than anyone else. This is the hallmark of competition. Any exchange rule prohibiting price improvement by definition interferes with a free and open market and thus violates Act's mandate sub (iv) above, and any such prohibition would also violate the Act's prohibition sub (iii) as it would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Act. It may be that the Exchange's owners and high frequency traders do not appreciate this competition, but the Exchange does not have the legal basis to ban it, and the narrowing of the spread benefits investors, so the Commission should encourage this type of trading.

Finally, "following the execution of the Contra-Side Orders, the trader cancels the Displayed Orders". Such cancelations are not evidence of fraud. Exchange rules allow any order not acted upon to be cancelled at any time and it is a good trading practice to do so. If the trader did not cancel the Displayed Orders, he would be providing a free stop loss to whomever traded with Contra-Side Orders. The trader has no obligation to provide a free stop loss and the Exchange cannot force the trader to do this. An illustration of this point is below:

Assume a trader is bidding between 26.73 and 26.75 for a total of 5,000 shares of stock. This is the Displayed Side (previously named Layered Side"). He then enters a "sell" for 5,000 order at 26.76 which is executed. The trader is now short 5,000 shares and if the stock goes up to 36.76, the trader would have lost $50,000, i.e. 5,000 times $10.00. On the other hand, if the trader is prohibited from cancelling the Displayed Side, his profit potential is stopped out at between one and three cents per share because if the markets starts to go down the person that bought the stock can always sell it back to the original trader at approximately $26.74. So if the trader does not cancel the Layered Side, he has an unlimited loss potential ($50,000 in this example where the stock rose $10) and a 2 cent profit opportunity. It makes no sense for anyone to make a bet with unlimited downside risk and an upside potential of only 2 cents, so of course, any rational trader will cancel the Displayed Side. Moreover, anyone trading on the Contra Side cannot expect to have a free guarantee against losing more than 2 cents. The resting bids are in effect free put options. It gives the any market participant the opportunity (but not the obligation) to sell at the price of the bid. The trader that cancels his bids is not a manipulator, just because he does not give away a free put option.

One bizarre argument that we have heard to justify labeling the Displayed Side as "manipulative" is that the trader does not "intend" to have them executed. This is an oxymoron. There is no doubt that the trader intended to enter the displayed orders. However, once the orders are entered, they are live actionable orders. Whether the orders will become executed or not is outside of the trader's control, so the word "intend" make no sense. It might be that the trader "hopes" that the orders will not be executed, but it's difficult to imagine how someone's hopes can possibly matter. People that trade the stock market hope for all kinds of things and their hopes do not turn real actionable orders into a manipulative scheme.

Of course, the exchange could make orders, once entered irrevocable, by prohibiting all cancels. If it wants to make such a rule, there would be no objection, but liquidity would dry up immediately and the Exchange would soon be out of business. What the Exchange cannot do is allow over 95% of its orders to be cancelled and selectively prosecute a few customers that provide un-welcome competition to its owners and large high frequency traders and accuse them of fraud when they cancel their orders. This violates Act's prohibition sub (i) above that makes unfair discrimination between customers illegal.

Disruptive Quoting and Trading Activity Type 2 (previously "Spoofing") as defined in the proposed rule is not manipulative and any prohibition of the practice would constitute a ban on competition and thus violate the Act.

For the purpose of the proposed Rule, "Disruptive Quoting and Trading Activity Type 2" is defined quoting and trading activity that includes a frequent pattern in which the following facts are present:

1) a party narrows the spread for a security by placing an order inside the NBBO; and
2) the party then submits an order on the opposite side of the market that executes against another market participant that joined the new inside market established by the order described in paragraph (1) above.

The proposed rule is once again unacceptably vague because of the words "frequent" and "pattern".

By definition any person involved in Disruptive Quoting and Trading Activity Type 2 pursuant to step (1) above has improved the NBBO on one side of the market. The alleged spoofer has also improved the other side of the market, because according to step (2) above the Contra-Side Order is executed, so that order must by definition also have improved the NBBO. Thus, all that the alleged manipulator does here is improve both the bid and the offer. In other words, he bids higher price, and offers to sell for less. What is claimed to be manipulation here is nothing more than competition at work. By definition, competition leads to buyers offering to pay a higher price and sellers offering to part with their goods for less. That is exactly what a free market is all about.

The proposed ban on what was previously labeled as Spoofing violates almost all of the above cited provisions of the Act. Banning price improvement is undoubtedly at odds with requirement Act's requirement sub (i) above as it is contrary to just and equitable principles of trade. It also violates requirement sub (iii) as it creates an impediment and obstructs the mechanism of a free and open market and it violates the provision sub (iv) as the rule would hurt investors and be contrary to the public interest as it would require investors to pay higher prices for stock and sell at lower prices. It is difficult to imagine a more harmful rule. It looks more like illegal price fixing than thoughtful market regulation.

Another objectionable fact is that Disruptive Quoting and Trading Activity Type 2 as defined here, not only depends on what the alleged spoofer does, but also depends on actions of an unknown third party. According to step (1) above an element of the proposed violation is that the bid or offer that improved the NBBO is joined by another market participant. It may be possible for a trader to know if his improved bid or offer is joined as required in step (1) above. However, given the anonymity of the market, it is impossible for a trader to prevent an anonymous third party from trading with the Contra-Side Order. If the Contra-Side Order is executed there is no way for the trader to know if the person who joined the improved NBBO traded with the Contra-Side Order, or some random investor, who saw the improved market and decided to take advantage of the better price. Thus, an element of Disruptive Quoting and Trading Activity Type 2 makes trader "A" guilty of Disruptive Quoting and Trading Activity Type 2 based on the actions of an unknown and uncontrollable trader "B".

It may be that the definition of Disruptive Quoting and Trading Activity Type 2 is not narrowly enough defined and what the Exchange really means is that the Contra-Side Order is at the same price as the limit price that improved the NBBO. This would be more in line with what other regulators have defined as spoofing. In other words, the market is 24.75 bid and a trader enters a 24.76 bid. Spoofing would be limited to a scenario where the same trader then enters a sell order at 24.76. If this is what the Exchange means, it should limit its definition accordingly. As it now stands, the definition includes the scenario where the trader enters a "sell" order at 24.77 that is taken by the person that joined the 24.76 bid.

However, even if the definition of spoofing were to be re-written to be more limited, the proposed rule remains problematic. If the trader that first entered the 24.76 bid, did not first cancel his buy order and entered a sell order at the same price, he would create a wash sale. Wash sales are already generally illegal, so there is no need to re-define the practice as Spoofing. There would be nothing wrong with the practice however if the trader first cancelled his bid. In that case he would have turned from a buyer into a seller at the same price. This happens all the time and there is nothing manipulative about it. People change their mind. There could have been bad news on the stock. Not allowing people to change their mind would of course create an impediment and obstruct the mechanism of a free and open market and thus violate the Act's requirement sub (iv) above.

The alleged spoofer is subjected to real market risk when he improved the NBBO by bidding 24.76. His bid could be "hit" instantaneously by any interested seller. The person that joined the 24.76 bid cannot complain of manipulation because he too is at risk. If the first bidder is not allowed to cancel, the second bidder is guaranteed against losses, because, if the market does not continue to go up, he can turn around and sell at 24.76 to the person that improved the NBBO by showing the 24.76 bid first,. If the second bidder does not want to actually want to buy stock at 24.76 he has a simple remedy: Don't bid 24.76. In fact, following the Exchange's flawed logic, why not accuse the person that joined the 24.76 bid of manipulation? After all, he apparently did not "intend" to have his 24.76 bid executed, so why not label the person that joined the bid as a manipulator as well?

What both of BATS' proposals have in common is that, if adopted, they would eliminate risk from front-running strategies employed by the Exchange's most cherished high-frequency trading owners and members. In both the case of Spoofing and Layering (now renamed Disruptive Quoting and Trading Activity Types 1 & 2), these most favorite members seek to trade with the Contra-Side Orders and use the original orders as a free stop-loss, i.e. a means to "get out" with limited or no loss if they are wrong. When the original orders cancel and their free put option disappears, they cry foul to the regulators, who seem only too eager to come to their rescue. In a free market, no one can trade without risk. The Commission must realize this and reject this proposal that will benefit high-frequency front-running at the expense of investors.

The Exchange has no jurisdiction over persons that are not members of the Exchange

Under the threat of being barred from the industry altogether, the Exchange proposes to be able to force its members to deny access to clients that the Exchange deems to be involved in Disruptive Quoting and Trading. If a client is cut off by one member, presumably all members would be prohibited from providing access to the client, or otherwise the provision would be toothless. The Exchange has no such authority and it cannot be fabricated it by adopting a rule, even if approved by the Commission.

The Commission has many powers at its disposal to end manipulative conduct and to protect investors and the public interest. There is no reason to believe that the Commission is not doing its job. However a privately owned exchange has no jurisdiction over American citizens who are entitled to due process under the law. BATS' proposal amounts to an illegal group boycott and cannot be approved by the Commission. Outrageously, the affected client is denied any form of due process. The accused person is not even entitled to be heard.

The proposed summary proceeding violates the Act

The Act requires a fair disciplinary process. BATS' proposes that a hearing be held within 15 days of notice. This leaves no time for discovery, which by necessity will make any hearing unfair[3]. The Exchange argues that this is necessary, because of alleged imminent "large" harm to investors. We see no such harm. To the contrary. The described trading strategies are in the public interest because they

---

[3] Section 6(d)(3) of the Act limits an exchange's ability to summarily suspend a member to a situation where the member has been expelled by another SRO or when the member is experiencing severe financial difficulties.

Interesting is also that the Exchange, just as in the original proposal ***admits*** that its proposed Rule would violate the Act: "The Exchange and other SROs were able to identify the disruptive quoting and trading activity in real-time or near real-time; nonetheless, in accordance with Exchange Rules ***and the Act*** (emphasis added), the Members responsible for such conduct or responsible for their customers' conduct were allowed to continue the disruptive quoting and trading activity on the Exchange and other exchanges during the entirety of the subsequent lengthy investigation and enforcement process.." *(SR-BATS-2015-101. Page 4)* narrow spreads, provide price improvement and accordingly reduce trading costs for investors. No false information is injected into the market and accordingly there is no manipulation. What really appears to be what the Exchange is complaining about is unwelcome competition. The Exchange's most cherished customers and its owners (who are also customers) would prefer to keep trading costs high at the expense of American investors. The Commission cannot permit this.

For the reasons set forth above, the Commission must reject the Exchange's proposed Rule in its entirety.

Respectfully submitted,

Samuel F. Lek
Chief Executive Officer