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**[1]

DATE: **December 13, 2019**

RE: **Recommendation of the Investor Advocate**
File No. SR-CboeEDGA-2019-012

RECOMMENDATION:

Disapprove the proposed rule change from the Cboe EDGA Exchange, Inc. to introduce a Liquidity Provider Protection Delay Mechanism.

I. Introduction

Pursuant to Section 4(g)(4) of the Securities Exchange Act of 1934 ("Exchange Act"),[2] the Office of the Investor Advocate is responsible for, among other things, analyzing the potential impact on investors of proposed rules of self-regulatory organizations ("SROs") and identifying areas in which investors would benefit from changes in SRO rules. We have reviewed a rule proposal from the Cboe EDGA Exchange, Inc. ("EDGA" or the "Exchange") to introduce a Liquidity Provider Protection Delay Mechanism,[3] and we believe it will have a

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[1] 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.

[2] 15 U.S.C. § 78d(g)(4) (2012).

[3] *See* Order Instituting Proceedings To Determine Whether To Approve or Disapprove a Proposed Rule Change To Introduce a Liquidity Provider Protection Delay Mechanism on EDGA, Securities Exchange Act Release No. 87096

detrimental impact on the majority of investors. Accordingly, we recommend that the Commission disapprove the rule proposal.

As proposed, the rule would delay all incoming executable orders on the Exchange for up to four milliseconds, while still permitting resting orders on the Exchange's book to be cancelled or modified without the delay.[4] The asymmetric application of this speedbump could allow liquidity providers on the Exchange to adjust resting quotations in response to other market data before those quotes would otherwise execute against other incoming orders.

According to EDGA, this differential treatment would protect liquidity providers by addressing cross-market latency arbitrage and thereby enable these market participants to make better markets in equity securities traded on the Exchange.[5] The Exchange believes that certain opportunistic trading firms with faster data connections are trading against otherwise stale quotes on the Exchange, and that slowing down all orders would address this problem.[6] EDGA argues that its proposed asymmetric speedbump, in addition to protecting non-displayed orders pegged to the midpoint of the National Best Bid and Offer ("NBBO") like non-asymmetric speedbumps already approved by the Commission, also could promote price-forming displayed liquidity from traditional market makers.[7] In other words, with the speedbump slowing down all other orders, including those from "faster" trading firms, the Exchange's existing market makers will face less

(Sept. 24, 2019), 84 Fed. Reg. 51657 (Sept. 30, 2019), File No. SR-CboeEDGA-2019-012, https://www.govinfo.gov/content/pkg/FR-2019-09-30/pdf/2019-21096.pdf [hereinafter EDGA OIP].

[4] *See* EDGA OIP, *supra* note 3, at 51657.

[5] *See* Securities Exchange Act Release No. 86168 (June 20, 2019), 84 FR 30282 (June 26, 2019), https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13537.pdf [hereinafter EDGA Notice].

[6] *See id.* at 30289.

[7] *See id.*

financial risk from quoting. With the advantage of additional time to receive additional market data and to update any stale quotes, the market makers may display quotes with even better prices and in even larger sizes.

In September 2019, the Division of Trading and Markets, acting under delegated authority, instituted proceedings to determine whether to approve or disapprove the rule proposal (the "EDGA OIP"), having already received 21 comments from 18 commenters.[8]

As noted in the EDGA OIP, the Exchange Act requires that the Commission determine that rules of a national securities exchange be designed, in general, to protect investors and the public interest, and, in relevant part, to not permit unfair discrimination between customers, issuers, brokers, or dealers.[9] With this in mind, the Office of the Investor Advocate has reviewed EDGA's proposed rule and the comments submitted. In short, we do not support EDGA's efforts to discriminate in favor of a certain class of market participants that submit a certain set of orders to the Exchange. As more fully described below, EDGA's proposed rule change appears unfairly discriminatory and inconsistent with investor protection and the public interest.

II. Analysis

A. The EDGA Proposal Unfairly Discriminates

As described in the OIP, the Commission is currently considering and seeking comment on whether EDGA's proposed asymmetric speedbump "would reduce cross-market latency arbitrage and improve market quality by enabling liquidity providers to maintain tighter spreads

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[8] *See* EDGA OIP, *supra* note 3. *See also* https://www.sec.gov/comments/sr-cboeedga-2019-012/srcboeedga2019012.htm.

[9] *See* 15 U.S.C. § 78f(b)(5) (2012).

for longer durations and with greater size[.]"[10] Setting aside questions about whether the new liquidity might be illusory, EDGA's asymmetric speedbump, as proposed, intentionally discriminates in favor of one category of liquidity providers: those capable of modifying their quotations on EDGA within four milliseconds following a change in price. Instead, now those investors lacking the ability to cancel or modify their orders within four milliseconds would face the risk of adverse selection when their limit orders are also at the best bid or offer on EDGA. As only a select group of fast-trading market makers will be able to exploit the four millisecond delay, the resting orders of all other classes of investors will still be left exposed to the alleged predatory arbitrage behavior.

Because the speedbump is discriminatory on its face, the relevant regulatory question should be whether the proposed advantage provided to a certain class of market participant is *unfair*. EDGA represents that the proposal merely "would offer strong incentives for liquidity providers to improve quote quality, and hence execution quality for investors, and would do so by offering an innovative solution to investors on a purely voluntary basis," and argues that this is plainly not unfair discrimination.[11] Although we recognize that the proposal ties the benefit to a specific market behavior (the ability to react to price movements within 4 milliseconds) rather than limiting the benefit to specified market participants (*i.e.*, registered market makers), the facially neutral proposal appears tailored to have a disparate impact on various EDGA liquidity

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[10] *See* EDGA OIP, *supra* note 3, at 51667.

[11] *See* Letter from Adrian Griffiths, Assistant General Counsel, Cboe Global Markets, dated August 22, 2019 ("EDGA Letter"), at 9, https://www.sec.gov/comments/sr-cboeedga-2019-012/srcboeedga2019012-6009676-190812.pdf.

providers.[12] We therefore believe it appropriate for the Commission to consider whether the subsidy to a subset of market makers at the expense of other liquidity providers constitutes unfair discrimination.

We agree with the Exchange that market makers provide an important service to investors,[13] and that certain forms of discrimination in their favor can be appropriate under the Exchange Act. However, this specific proposal strikes an inappropriate balance and is insufficiently designed to enhance market quality. We believe there is a significant imbalance between, on the one hand, the speculative market quality benefits that might emerge from the asymmetric speedbump and, on the other, the undisputed discriminatory benefit provided to the class of market makers capable of using the speedbump to their advantage.

B. The Proposed Market-wide Benefits Appear to be Too Speculative

The Commission should carefully consider the weight to be given, if any, to speculative benefits to overall market quality. Although the proposal describes how the asymmetric speedbump could *potentially* result in price improving quotations to the benefit of retail and institutional investors in the market,[14] there is no guarantee that such improvements would occur.

We understand EDGA's argument for the possibility that new quotations from existing market makers (or new entrants) would tighten the spread on EDGA because it would be easier

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[12] *See id.* at 9 ("Naturally, market participants that routinely enter two sided quotations, and stand ready to buy or sell to investors, would benefit from the Proposal in relative proportion to the amount of liquidity that they provide").

[13] *See id.*

[14] *See* EDGA OIP, *supra* note 3, 84 Fed. Reg at 51667 ("the Exchange's assertion that the proposal would reduce cross-market latency arbitrage and improve market quality by enabling liquidity providers to maintain tighter spreads for longer durations and with greater size").

to cancel orders as the market moves against them.[15] We are concerned, however, that speculation about the potential for broader market-wide benefits seems to serve as the basis for allowing this significant discrimination. Under the proposal, the primary way that retail investors would stand to benefit is if they can interact with these specific quotes in EDGA. With the EDGA quotes not part of the NBBO, displayed prices would not benefit investor trades on other venues. Other have raised the same concern.[16]

Importantly, many investors appear to have raised an even more significant concern – market quality will actually decrease under the proposal. It appears possible that the proposal "will increase quote fading and reduce fill rates for institutional investors, leading to poor execution outcomes."[17] The proposal will also add significant complexity to the markets and, as others have noted, "increases in market complexity benefit the most sophisticated market participants to the detriment of less sophisticated investors, and raise costs for everyone."[18]

In effect, investors are being asked to accept the risk that the rule proposal degrades market quality without being able to count on any definite benefit. It can be appropriate for the Commission to consider how investors may indirectly benefit from a rule change. However, given the goals described in the proposal, it would not seem appropriate to expect such indirect benefits to materialize here. The EDGA proposal is designed to reduce the overall execution risk for a certain class of market makers, with the hope that these market makers voluntarily respond

[15] *See id.* at 51661.

[16] *See*, *e.g.*, Letter from Mark D. Epley, General Counsel, Managed Funds Association, dated October 22, 2019 ("MFA Letter"), at 3 ("EDGA liquidity providers will tend to join an existing quote in order to maximize the ability to observe away executions, meaning that overall market quality will not improve.")

[17] *See* MFA Letter at 2.

[18] *See* Letter from Dorothy Donohue, Deputy General Counsel, Investment Company Institute, dated October 21, 2019 ("ICI Letter"), at 3.

by taking on additional risk of quoting tighter spreads for longer durations and with greater size.[19] There is, however, no requirement that the market makers do so. Further, even if the market makers do respond in that fashion, the Commission must consider the likelihood that these market makers will also use the speedbump advantage to avoid the execution risk presented by the orders of other ordinary investors as well. Displayed but unattainable prices do not benefit investors. While the proposed speedbump is a guaranteed discriminatory benefit for certain market makers, there do not appear to be definite benefits for retail or institutional investors under this proposal.

C. The Academic Literature Should Be Given Significant Consideration

We remain concerned that a prior approval order, originally issued via delegated authority and ultimately set aside by the Commission,[20] too quickly distinguished an academic study of TSX Alpha,[21] a Canadian exchange that implemented an asymmetric speedbump. That Order suggested, in a single paragraph with insufficient data analysis, that studying the effects "may not be relevant" to the Commission's evaluation of that proposed speedbump.[22] We believe that the Commission should afford academic findings meaningful weight in its

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[19] *See* EDGA OIP, *supra* note 3, 84 Fed. Reg at 51667.

[20] *See* Chicago Stock Exchange, Inc.; Notice of Filing of Amendments No. 1 and No. 2 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendments No. 1 and No. 2, To Adopt the CHX Liquidity Enhancing Access Delay on a Pilot Basis, Exchange Act Release No. 81913 (Oct. 19, 2017), 82 Fed. Reg. 49433 (Oct. 25, 2017) (File No. SR-CHX-2017-04) https://www.govinfo.gov/content/pkg/FR-2017-10-25/pdf/2017-23122.pdf. *See also* In the Matter of Chicago Stock Exchange, Inc., Order Setting Aside the Order by Delegated Authority Approving SR-CHX-2017-04, Exchange Act Release No. 34-84337 (Oct 2, 2018), 83 Fed. Reg. 50720 (Oct. 9, 2018), https://www.govinfo.gov/content/pkg/FR-2018-10-09/pdf/2018-21761.pdf.

[21] *See* Haoming Chen, Sean Foley, Michael Goldstein & Thomas Ruf, The Value of a Millisecond: Harnessing Information in Fast, Fragmented Markets, at 6 (Nov. 18, 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860359 [hereinafter, The Value of a Millisecond].

[22] *See supra* note 20, 82 Fed. Reg. at 49444.

consideration of such proposals. Applicable real-world studies should inform the Commission's data-driven consideration, rather than be summarily dismissed for their differences.[23]

As other commenters have noted, this particular academic study found that the asymmetric speedbump on TSX Alpha "segments order flow and increases profits for fast liquidity providers on that venue at the expense of other liquidity providers and aggregate market quality."[24] Commenters have also discussed a study published by the Investment Industry Regulatory Organization of Canada and the Financial Markets Department of the Bank of Canada (IIROC/BC), noting the conclusions that the speedbump "did not impact market-wide liquidity" and the study could not "identify any significant impacts on effective spreads, price impact or quoted depth."[25] Even this study, which challenges some of the academic findings, fails to provide evidence that the proposed speedbump will actually benefit investors.

D. Conclusion

If an exchange seeks to introduce measures that create significant discrimination, the exchange must clearly demonstrate that the proposed discrimination is not unfair. Here, EDGA has failed to make a showing that the speculative enhancements to market quality are proportionate to and would provide balance against the clear advantage the asymmetric speedbump would certainly provide to a small set of liquidity providers. Only definite market-

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[23] *See* Rick A. Fleming, Investor Advocate, SEC, RE: Recommendation of the Investor Advocate, File No. SR-CHX-2017-04 (Feb. 27, 2018), https://www.sec.gov/comments/sr-chx-2017-04/chx201704-3169295-161957.pdf.

[24] *See* The Value of a Millisecond, *supra* note 21, at 1.

[25] *See* Anderson, Andrews, Devani, Mueller, Walton, "Speed Segmentation on Exchanges: Competition for Slow Flow," Bank of Canada Staff Working Paper 2018-3, at page 16 (January, 2018), available at http://publications.gc.ca/collections/collection_2018/banque-bank-canada/FB3-5-2018-3-eng.pdf ("IIROC/BC").

wide benefits to retail and institutional investors could make such a proposal balanced, and the comments and data available make it clear that no such benefits could be expected.

Accordingly, we recommend that the Commission disapprove the EDGA proposal.