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Securities and Exchange Commission
100 F St. NW
Washington, DC 20549-9303
Rule-comments@sec.gov

Re: BATS Market Close

File SR-BatsBZX 2017-34

Dear SEC:

Here are my comments on the BATS BZX proposal to match market-on-close (MOC) orders in competition with the closing auctions on the primary listing exchanges.

Summary:

- This is another round in the old debate of “Who owns the quote?”
- There needs to be a rethink of the role of intellectual property in financial services.
- The boundaries between exchanges and brokers are blurred. Brokers routinely pair off MOC orders.
- The closing price is the most important price of the day.

¹ All opinions are strictly my own and do not necessarily represent those of Georgetown University or anyone else for that matter.

- Pairing off MOC orders won't harm price discovery.
- The SEC should examine whether listing fees are sufficient to cover exchanges' regulatory duties.

Background

The BATS Exchange has proposed to match market-on-close (MOC) orders that will execute at the closing price of the primary listing exchange. At 3:35 pm, BATS will accept the matching MOC orders and reject the MOC orders that do not match. BATS will also announce the volume of the match. The price will be set not by the activity of orders interacting on BATS, but by the official closing price on the primary listing exchange.

Needless to say, the primary listing exchanges don't like this proposal because it could divert orders and revenue away from their closing auctions. On the other hand, many brokers and investors like the idea as the additional competition may lower their trading costs.

This is another round in the debate over "Who owns the quote?"

BATS proposes to execute trades based on prices generated elsewhere within the National Market System, and the primary listing exchanges are crying foul. The use of prices generated elsewhere is decried as "free riding" off of their substantial investments in closing auction technology.

This is part of the never-ending debate over market data. Once upon a time, long, long ago in our local galaxy, the "ticker cases" decided that market data were the intellectual property of the exchanges that generated that data.² The exchanges could do whatever they wanted to with their proprietary data, even refuse to sell it to competitors. Congress didn't like that and responded with the 1975 "National Market System" amendments to the Securities Exchange Act of 1934. This resulted in the Stalinist collectivization of market data into the consolidated tape that we all know and love. Market participants are permitted to engage in and price trades based on that data.

There is a similar precedent in the futures market. The ICE WTI cash-settled crude oil futures contract settles using the physically-settled NYMEX WTI price. Precedents thus indicate that BATS should be allowed to use the officially disseminated closing prices for its product.

There needs to be a rethink of the role of intellectual property in financial services.

² From the SEC Concept Release: Regulation of Market Information Fees and Revenues <https://www.sec.gov/rules/concept/34-42208.htm>; Board of Trade v. Christie Grain & Stock Co., 198 U.S. 236 (1905); Hunt v. New York Cotton Exchange, 205 U.S. 322 (1907); Moore v. New York Cotton Exchange, 270 U.S. 593 (1926).

The primary listing exchanges raise the issue of others free riding on the investments they have made in their closing auctions. There is a serious need to rationalize intellectual property protection in financial instruments. In equities there is virtually no protection for innovations, while the nature of futures clearing leads to long-lived protection for futures contracts. Serious thought needs to go into coming up with a coherent and rational scheme for the protection of intellectual property in order to foster productive innovation. However, a detailed discussion of this problem is left for another venue.

The boundaries between brokers and exchanges are increasingly blurred.

Both brokers and exchanges help to connect buyers with sellers and to determine a price. For historical reasons, they have been regulated in very different ways. When the Securities Exchange Act was passed, there was one dominant stock exchange that basically was the U.S. equity market.³ In a political compromise, exchanges were deputized as self-regulatory organizations (SROs) that were tasked with enforcing U.S. securities laws. Off-exchange brokers were regulated by the NASD, which later merged with NYSE Regulation and evolved into FINRA.

Brokers routinely engage in trades based on prices that have not yet been generated. For example, they accept VWAP trades from their customers that will be priced according to the VWAP over some future period such as the rest of the day. My understanding is that they also routinely accept and pair off MOC orders. It would appear that BATS is merely attempting to do what any broker can do: agree to execute some orders at the closing price and reject the rest. If brokers can do it, why not exchanges?⁴

Congress intended SRO rule filings to be innocent until proven guilty.

In §916 of Dodd-Frank, Congress specified strict deadlines for the SEC to process SRO rule filings. Furthermore, if the SEC did not process the rule filings in a timely manner, the statute holds that the rule change “shall be deemed to have been approved by the Commission.” This follows the basic philosophy of SRO-based regulation: the SROs generally know what they are doing and SRO rule filings should be deemed innocent until proven guilty.

However, this is not just a routine unopposed rule change. This particular rule change has generated substantial controversy and numerous comment letters. While the precedents regarding use of market

³ In addition, there were several smaller “regional” exchanges along with an over-the-counter market.

⁴ I continue to believe that it was a mistake for the then-Commission staff to shoot down Nasdaq’s reasonable request to offer VWAP orders. The expressed reason was a concern over adequate risk controls, not a general concern over an exchange doing something that brokers also did. See <https://www.sec.gov/rules/sro/nasdaq/2013/34-68629.pdf> and my comment letter at <https://www.sec.gov/comments/sr-nasdaq-2012-059/nasdaq2012059-1.pdf>

data discussed above suggest that the proposal be approved, commenters raise the issue that the proposal may affect the quality of the closing price. This is a serious objection that deserves close analysis.

The closing price is the most important price of the day.

The official closing price is the most important price of the day. It is the price that is generally used by mutual funds to price mutual fund shares, and the price used by brokers to make margin calculations. Inaccurate prices could result in retail mutual fund customers buying or selling mutual funds at the wrong price. An inaccurate closing price could result in erroneous margin calls or forced margin selling. There are many other uses as well, including the pricing of various derivative contracts. For this reason, it is in the public interest that the closing price be accurate. If the BATS proposal would seriously degrade the quality of the closing price, then it should be rejected. However, I do not believe that the BATS proposal will harm the quality of the closing price.

Pairing off MOCs 25 minutes before the close won't hurt price discovery.

Several commenters opine that the BATS proposal will result in "fragmentation" of the closing auction. It should be noted that Nasdaq and NYSE-Arca also hold closing auctions that compete with the closing auctions of the primary listing exchanges. These auctions provide an important backup to the primary listing exchanges, but also "fragment" the market as well.

The BATS proposal is to pair off orders at 3:35 pm, 25 minutes before the official close of regular trading hours. BATS will then reject the unpaired orders. In trading time, 25 minutes is an eternity. Markets will have plenty of time to digest the information generated by the BATS product. Indeed, by giving market participants time to digest the information, investors may make more informed decisions about how they will trade going into the close.

Note that the BATS proposal is to pair off only MOC orders that match and to reject the rest. This means that those orders would not have affected the closing price at all. With an equal number of buy and sell orders, they exactly equal out with no impact on the closing price.

Off-exchange brokers already pair off MOC orders in a way similar to what BATS proposes. This implies that BATS will be mostly competing with these off-exchange brokers. Any market share that the BATS product gets will come mostly from those MOC pairings currently executed off-exchange. This will reduce any potential impact, either in price or quantity, on the primary listing exchanges' closing auctions.

Commenters bring up some edge cases in which there are no trades in the official closing auction. Each primary listing exchange has procedures in place for disseminating an official closing price in such cases. The sophisticated market participants who can place MOC orders into the BATS system (which is not

something one can do from typical retail online order screens) are presumably aware of such risks and willing to accept them.

Manipulation is always an issue with auctions.

Designing an opening or a closing auction is much more complex than it might seem to some observers. When I was a visiting academic fellow at Nasdaq, I had the opportunity to participate in the design of their closing auctions. Auctions are very tricky because of the knife-edge nature of executing at one precise moment in time. There are numerous gaming possibilities that can be used to manipulate the auction price. For example, placing large orders and then cancelling them prior to the auction is a form of spoofing.

Another manipulation would be to place a large MOC order in one direction, and then attempt to manipulate the closing auction in the other direction. By locking in a very large buy MOC at 3:35 pm with assured execution, a manipulator could then attempt to manipulate the closing auction by sniping large sell orders into the market just before the close. However, it is unlikely that the BATS proposal will increase manipulation of the close. The proposal is unlikely to induce a substantial increase in MOC orders, just move them from other venues to BATS. Incentives to manipulate already exist with other MOC orders on the primary listing exchange as well as with off-exchange MOC orders through brokers. Both sides of the MOC orders that are paired off have the opposing incentives to manipulate. Finally, such manipulation is illegal and presumably would be spotted by the regulators.

The SEC should examine whether listing fees are sufficient to cover exchanges' regulatory responsibilities.

Primary listing exchanges have extremely important regulatory responsibilities to monitor issuers' continued compliance with listing requirements. This costs money. Creating and operating a fair and orderly closing auction also costs money.

Listing exchanges now compete fiercely for new listings. The listing fees charged by the exchanges are an important dimension in this competition. The recent addition of new listing venues such as IEX and BATS raises the specter of a race to the bottom in exchange listing fees. The exchanges will be tempted to charge lower listing fees to attract listings, and then they will be tempted to cut expenditures on regulation in order to avoid losing money from their listing responsibilities.

While Congress has effectively decided that anyone can do anything with market data, this does not necessarily ensure that, in this hyper-competitive environment, exchanges will have sufficient resources to properly execute their regulatory responsibilities. Rather than limit competitive use of the data, the SEC should explore whether listing fees are sufficient to properly fund the market close and other regulatory responsibilities of the primary listing exchanges.

Respectfully submitted,

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