



January 23, 2017

Via Electronic Mail

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

**Re: CHX Liquidity Taking Access Delay
Release No. 34-79608; File No. SR-CHX-2016-16**

Dear Mr. Fields:

I. INTRODUCTION

KCG Holdings, Inc. (“KCG”)¹ submits this letter to the Securities and Exchange Commission (“Commission”) to comment on the proceedings to determine whether to approve or disapprove the above-referenced proposed rule change filed by the Chicago Stock Exchange (“CHX” or “Exchange”).² The Exchange proposes adopting a rule change to introduce the CHX Liquidity Taking Access Delay (“LTAD”), which would subject liquidity-taking orders on CHX to a 350-microsecond processing delay or “speed bump” but would not delay liquidity-providing orders.

¹ KCG is a leading independent securities firm offering investors a range of services designed to address trading needs across asset classes, product types and time zones. As an electronic market maker, KCG commits its capital to facilitate trades by buyers and sellers on exchanges, ATSS, and directly with clients. We combine advanced technology with exceptional client service to deliver greater liquidity, lower transaction costs, improve pricing, and provide execution choices. KCG has multiple access points to trade global equities, fixed income, currencies and commodities through voice or automated execution.

² See Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Adopt the CHX Liquidity Taking Access Delay, Exchange Act Release No. 79608 (December 20, 2016).



As discussed below, KCG is generally supportive of initiatives designed to encourage liquidity provision. We agree with CHX that the LTAD would encourage liquidity providers to make tighter and deeper markets on the Exchange, but we also acknowledge certain potential side effects highlighted by several commenters including that the speed bump might render CHX quotations somewhat less accessible.

In our view, CHX's LTAD proposal clearly demonstrates how the proliferation of business-driven structural alterations by exchanges threatens to further complicate an already inordinately complex exchange landscape. Indeed, we expect exchange operators to continue experimenting with their business models – introducing varying speeds of access, additional order types, and differing fee schedules - in a never-ending effort to compete with one another and broker-dealers for greater market share and revenue. Unfortunately, this relentless focus on commercial interests has led exchanges to migrate away from their SRO origins and, coupled with issues around the Order Protection Rule, now threatens the utility of our national market system. The impact of this dynamic can be seen in:

- **Continued fragmentation** among lit markets, with more than a dozen registered exchanges;
- **Excessive complexity**, with each exchange presenting various structural nuances including differing priority rules, varying fee schedules, hundreds of order types and now potentially differing speed bumps; and
- **Constant cost increases for market participants**, who are effectively required by regulation to maintain access to all exchanges and must absorb related costs such as connection ports, co-location fees, and market data feeds.

KCG believes that rather than allow market complexity to continue to intensify via ad hoc exchange rule changes, the Commission should instead initiate its “holistic review” of U.S. equity market structure focusing particularly on the forces driving fragmentation and complexity, specifically, exchanges’ SRO status and the Order Protection Rule.

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II. CHX LTAD OVERVIEW

The Exchange proposes to adopt the LTAD that would impose a 350-microsecond delay on all liquidity-taking orders (and related cancel messages) before being processed by the CHX matching engine against resting orders on the CHX book. In contrast, all other orders, including liquidity-providing orders (and cancel messages for resting orders) would be immediately processed without delay.

The Exchange asserts its speed bump will enhance displayed liquidity and price discovery in NMS securities without adversely affecting the ability of market participants – other than latency arbitrageurs – to access liquidity at CHX. According to CHX, the LTAD’s objective is to prevent market makers from getting adversely selected or “picked-off” by latency arbitrageurs, which will encourage them to make tighter and deeper markets.

CHX notes that the LTAD is similar to the speed bump recently implemented by IEX³ in that both employ an identical-length delay of 350-microseconds meant to protect resting liquidity from latency arbitrage, but they differ in that the LTAD is designed to protect displayed liquidity whereas IEX is not.

The Commission requested comment CHX’s proposed rule change to adopt the LTAD in September 2016. Twenty commenters submitted letters on the proposed rule change, including a response to certain comments by the Exchange. Given the range of feedback received on the filing, in December 2016 the Commission instituted the above-referenced proceedings requesting further comments to assist it in determining whether to approve or disapprove the proposed rule change.

³ In June 2016, the Commission approved IEX as an exchange including its intentionally delayed market with protected quotation status.



III. DISCUSSION

A. CHX's LTAD Speed Bump Presents a Mix of Advantages and Disadvantages

In our view, CHX's LTAD proposal presents numerous benefits as well as a few potential drawbacks. On the positive side, the speed bump is likely to encourage liquidity providers to make tighter and deeper markets on CHX as delaying liquidity-taking orders will reduce the likelihood that market makers will get picked-off.⁴ It would also lower the barrier to entry for new liquidity providers – and decrease costs for existing liquidity providers - by allowing them to compete and add liquidity without having to make significant technology and infrastructure expenditures devoted to avoiding adverse selection, which would ultimately lead to decreased costs for investors. In addition, as a liquidity provider, we acknowledge that the LTAD is likely to be commercially beneficial for market makers and other liquidity providers.

Several commenters have cited, however, possible drawbacks to CHX's proposal. In our view, there is a potential that the LTAD speed bump may cause adverse side effects, such as making CHX quotes somewhat less accessible to market participants. In addition, it might delay or impair price discovery to the extent it would impose an additional 350 microsecond delay for ETFs and other instruments to move in line with underlying fair value.

CHX's LTAD proposal presents a mix of clear benefits and potential side effects that the Commission must carefully weigh and it is difficult to predict the precise impact CHX's access delay - or a speed bump introduced by any exchange - would have on national market system attributes such as liquidity, spreads, and quotation access. ***Regardless of its potential advantages or drawbacks, however, we are certain***

⁴ There has been a lively debate lately surrounding what is referred to as "quote fade" and mechanisms designed to combat it, but until now there has been decidedly less discussion about adverse selection and related costs borne by market makers (and ultimately investors) of abating pick-offs. On the whole, we believe this type of speed bump – one that is designed to encourage liquidity provision – is likely to be beneficial for liquidity providers on CHX and for CHX's displayed market and therefore is likely to enable market makers to provide tighter and deeper quotations for investors.



that the LTAD – and speed bumps introduced on other lit markets – would magnify the complexity of U.S. equity market structure. Therefore, before approving or disapproving CHX’s proposal or other exchange rule filings varying speeds of access, the Commission should carefully consider the impact any such proposal would have on market structure complexity. In our view, the Commission should conduct its holistic review of U.S. equity market structure with an eye towards protecting the needs of the national market system as a whole and with a particular focus on complexity driven by exchange iteration and their SRO status.

B. Market Structure is Overly Complex

The U.S. equity market landscape is highly fragmented among more than a dozen exchanges, several dozen dark pools and numerous broker-dealers all fiercely competing for order flow. Securities regulations – including the Order Protection Rule of Regulation NMS (“Reg NMS”) and the long-standing obligation to provide clients with “best execution” – essentially require broker-dealers to connect directly or indirectly to all exchanges as well as many non-exchanges venues. Because market participants must connect to *all* exchanges and because one of the primary ways exchanges compete with one another is by offering differing mechanisms that alter the structure of their individual market (*e.g.*, fees schedules, order types, access delays, priority rules, *etc.*), each unique structural change by a single exchange has the potential of creating significant additional complexity and risk for all market participants across the national market system.

The structural feature at issue here – order delays or speed bumps - began gaining traction following the Commission’s June 2016 approval of IEX’s application to become an exchange along with its issuance of a related interpretation that delays of less than one millisecond are “de minimis”. During the IEX application process, many observers predicted that providing IEX with protected quote status despite its speed bump would inevitably spur other exchanges to adopt similar measures that would ultimately increase market complexity. In fact, following the IEX decision, CHX was the first exchange to file for its own delay mechanism, closely followed by a Nasdaq



filing⁵ seeking approval for a special function – the “Extended Life Priority Order Attribute” - to slow the market for some traders - and we understand that NYSE may be considering implementing its own speed bump.

C. A Holistic Review is Necessary

Despite the above-noted potential commercial benefits of CHX’s LTAD proposal for market makers on the Exchange, rather than continue to address business-driven structural changes like varying speeds of access on an *ad hoc* basis in response to exchange rule filings, we believe it is imperative for the Commission to take this opportunity to initiate the long-requested “holistic review” of equity market structure with an eye towards decreasing market complexity. The Commission should particularly focus on two key sources of fragmentation and complexity: exchanges’ SRO status and the Order Protection Rule.

And, given the following circumstances, now is the time to initiate a fundamental review of equity market structure:

- Leadership at the Commission is about to undergo a major change (including new chairperson, two new commissioners, and a new director of Trading and Markets);
- The Commission recently initiated a limited Reg NMS review pursuant to the Regulatory Flexibility Act that could readily provide a platform for a more expansive review;
- Commissioner Michael S. Piwowar has called for the re-examination of Reg NMS in light of “substantial changes in technology, economic conditions and other factors in the decade” since the rule-set was initially adopted;⁶ and
- Most significantly, CHX’s LTAD proposal illustrates how exchanges continue to push business-driven structural iterations that impact our national market

⁵ See Notice of Filing of Proposed Rule Change to Adopt a New Extended Life Priority Order Attribute, Exchange Act Release No. 79428 (Nov. 30, 2016). Nasdaq’s proposal would allow displayed orders the commit to a one second resting period to receive higher priority than other displayed orders of the same price on the Nasdaq book.

⁶ See Statement Regarding Publication of List of Rules to be Reviewed Pursuant to the Regulatory Flexibility Act, Commissioner Michael S. Piwowar, Sept, 15, 2016.



system and collectively threaten to further complicate an already overly complex equity market structure.

1. SRO Status of Exchanges

In our view, several developments have rendered the self-regulatory organization model outdated and necessitate eliminating exchanges' SRO status. First, exchanges have evolved from member-owned market utilities to multi-national multi-billion dollar competitive enterprises. As for-profit businesses competing with one another, exchanges continually alter their market structure and create new products and services – including order types, speed bumps, fee schedules, and priority rules - with a view to increase market share and maximize shareholder returns. Given exchange fragmentation among more than a dozen distinct venues, persistent structural iteration by exchanges creates significant complexity and risk for the national market system and all market participants. Unlike broker-dealers, however, exchanges' historical SRO status means they are essentially immune from liability flowing from risks they create for the market. Elimination of SRO status would increase incentives for exchanges to minimize market complexity and risk.

Second, exchanges no longer perform the majority of their regulatory functions but instead outsource those operations to the Financial Industry Regulatory Authority ("FINRA"). Despite having delegated their regulatory functions, exchanges' status as SROs and the related benefits (*e.g.*, absolute immunity and limited liability under SRO rules) have been left untouched. Third, exchanges' SRO status creates conflicts of interest issues⁷ and anti-competitive concerns as, due to exchanges' commercial interests and changes to the way the securities markets operate, exchanges now compete directly for order flow and other services with the broker-dealer community over which they have regulatory authority flowing from their SRO status.

In our view, the Commission should eliminate exchanges' status as SROs. Exchange activities are predominantly commercial in nature and thus they should no longer be

⁷ See letter from IEX Chief Market Policy Officer, John Ramsay, to the Commission dated September 9, 2016, concerning NYSE co-location services fees (noting "... exchanges' incentive to increase profits may, at times, directly conflict with their role as self-regulatory organizations and gatekeepers for markets that participants are required by regulation to access.").



considered SROs. Eliminating exchanges' SRO status would motivate exchanges to invest appropriately towards reducing operational failures and avoid imposing unnecessary risks on market participants. It would also re-align the regulatory framework with reality, which is that FINRA already performs most self-regulatory functions on behalf exchanges. Finally, elimination of SRO status held by more than a dozen exchanges and unifying self-regulatory functions under FINRA would streamline the regulatory landscape and allow for a single rule-set instead of dozens of differing SRO rules and interpretations.

2. Order Protection Rule

KCG supports a universal review of all facets of U.S. equity market structure, but with respect to the most immediate concerns about fragmentation and complexity, we believe the Commission should prioritize its review of the Order Protection Rule.⁸ The Order Protection Rule – which seeks to ensure that investors receive best price for their orders by prohibiting “trading-through” any exchange quote at the best price - effectively obligates broker-dealers maintain connections to and obtain data from *all* exchanges displaying protected quotations regardless of level of liquidity or execution likelihood offered by a given exchange. As noted by others, this requirement has resulted in exchange proliferation that in turn has increased market fragmentation and complexity. The Order Protection Rule has also resulted in numerous order types at each venue designed to comply with the prohibition against trading-through another order.

In our view, the Commission should revisit the fundamental purpose of the Order Protection Rule in light of the current market environment and consider eliminating or amending the rule with the goal of defragmenting the market and reducing complexity.

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⁸ See Regulation NMS Rule 611.



KCG greatly appreciates the opportunity to comment on this matter and would be pleased to discuss these comment in greater detail. If you have questions, please do not hesitate to contact John A. McCarthy (at [REDACTED] or [REDACTED]) or Tom Eidt (at [REDACTED] or [REDACTED]).

Sincerely,

/John A. McCarthy/

John A. McCarthy
General Counsel