Market Commentary

December 1, 2016

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Down the Slippery Slope

You know the nearer your destination
The more you're slip slidin' away
--Paul Simon

Introduction

After the SEC decided to leave all marked trails in approving IEX's 350 microsecond speed bump, it was just a matter of time before some other exchange decided to veer off-piste in search of fresh powder.

The first intrepid exchange is the Chicago Stock Exchange which has applied to impose a 350 microsecond speed bump on liquidity-taking orders while proposing to allow unencumbered alteration of posted liquidity. This is an interesting idea. It might even be a good idea, but we think that there may be some profound implications of putting this particular trail on the map. In this quick note, we argue that approval of this proposal would fundamentally dilute the value of quotes *across the entire market*.

The Crux of the Matter

While numerous substantive objections have already been raised by others in comments to the SEC, we believe that the full impact of this proposal has not yet been addressed.

The crux of the matter, as we see it, is that a quote from CHX under this proposal would not be the same as a firm, immediately accessible quote from another exchange, but CHX's application asks the SEC to treat their quotes *as if* they are the same. CHX would be offering contingent liquidity, while other exchanges would be offering liquidity with no strings attached.

CHX's quotes would be inherently less valuable, but in an industry that is as heavily regulated as any in the US economy, the SEC is in a position to declare the two quotes equivalent. This is where an economist would cite Gresham's law, a monetary principle that states that bad money drives good money out of circulation. In our example we would have two currencies (quotes) that are assigned the same value (protected status) but where one, CHX's contingent quote, is of lower value. Put yourself in the position of a market maker. If you are making a two-sided market, wouldn't you be willing to bid and offer more aggressively if you are given a time window to alter your quote before your quote can be accessed? Of course you would. That's the whole premise of this proposal.

Take the argument one step further. Since contingent quotes should, all else equal, be more aggressive than firm quotes, contingent quotes should rise to the top of the NBBO heap more often than firm quotes. Under the terms of competition defined by Reg NMS, he who quotes most aggressively wins. Eventually, the other exchanges will be forced to adopt contingent quotes as well in order to enjoy the regulated benefits of quote protection.

Viewed this way, we see that the CHX proposal encompasses nothing less than the essential nature of liquidity in US markets. It may well be that a market of more aggressive but contingent quotes is preferable to wider but firm markets, but we need to be very clear that the CHX proposal is asking the SEC to make this very fundamental decision. Such a decision demands thorough examination. Slip slidin' won't cut it this time.

Conclusion

There is far more at stake in CHX's proposal than first meets the eye. The CHX application raises a fundamental market-design choice that has so far flown under the radar, a choice that has implications that extend way beyond a regional exchange. If the CHX application is approved, *competitive pressures combined with Reg NMS will compel all exchanges to adopt this form of non-firm quote*. We can expect these quotes to be tighter than in the current regime, but these tighter quotes will be subject to cancellation before they can be accessed. Whether a market with tighter, non-firm quotes is to be preferred to a market with wider but firm quotes is an open question, but, make no mistake, the CHX proposal poses this fundamental choice. Investors who find the level of quote-fading in the current market environment to be already too high, would do well to take heed.