September 15, 2014

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090


Dear Sir or Madam,

Decimus Capital Markets, LLC ("DCM") appreciates this opportunity to comment on recent developments in the so-called "order type controversy." With the mechanisms of special order type handling being the subject of controversy, it is beyond serious question that accommodation of high-frequency trading strategies via these order types is a central issue for our current equity market structure and its ongoing evaluation by the U.S. Securities and Exchange Commission ("SEC"). This controversy, which dates back to at least 2012, focuses on complex order types and exotic modifiers, including "post only" and "hide and light" functionalities and intermarket sweep orders ("ISOs").

The order type controversy goes beyond the sheer complexity created by ever-expanding order type menus and focuses on problems created by specific order types, their inadequate documentation and disclosure, and their interaction with order types traditionally used by the investing public. While a recent proprietary report naively found "no evidence that exchanges or automated proprietary traders have conspired to create 'killer' order types that disadvantage end investors, as some critics have contended," the increased level of regulatory scrutiny and numerous rule changes filed by different exchanges paint a different picture. In fact, these rule changes and additional disclosure documents often describe their purpose in terms of correcting, clarifying, and simplifying order types and their complex menus. Moreover, these developments often reveal significant disclosure lapses in the past and sometimes involve undisguised admissions of such lapses by securities exchanges.


3 Peter Chapman, No Order Type Conspiracy, Rosenblatt Study Says, TRADERS MAG., Aug. 2013, at 8, 8 (quoting the report).
DCM commends this trend towards greater transparency, but the order type controversy is far from resolved. Our comment letter addresses a recent rule filing by the New York Stock Exchange (“NYSE”) as an illustration of securities exchanges’ common practice of introducing complex order types in a manner deliberately intended to introduce asymmetries into the marketplace. DCM believes that this rule change proposed by NYSE, if approved as filed, would set an undesirable precedent encouraging both NYSE and other exchanges to continue introducing features that cater to high-frequency traders at the expense of the investing public, while increasing the complexity of securities markets, contrary to the goals of the National Market System. The proposal creates an impression that it might have been designed by someone intimately familiar with high-frequency trading strategies, including those conducted on competing exchanges and enabled by improperly documented and disclosed order types. It is somewhat surprising that this filing, despite its significance and the recent attention paid to order type practices as a part of a nationwide debate on market structure, has attracted little response by experts versed in the matter, judging by the lack of comment letters. DCM believes this is due in part to the complexity of this filing, which provides little color as for the intended utilization of such order types.

The NYSE filing appears to be inconsistent with Section 6(b)(5) of the Securities Exchange Act of 1934 requiring securities exchanges “to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and . . . not . . . permit unfair discrimination between customers, issuers, brokers, or dealers.” Furthermore, as described below, some features proposed in the rule filing either do not comply with Regulation NMS or are unlikely to be implemented and / or used in a compliant manner. Moreover, the proposed filing is contrary to much-publicized statements by the leadership of Intercontinental Exchange Group, the parent company of NYSE Euronext, on order types and the maker-taker pricing model. Accordingly, the approval of this filing is likely to escalate the order type controversy, taking into account the mounting evidence on the improper use of certain order types.

Our comment letter focuses on the advantageous features incorporated into the “post-only” functionality (known on NYSE as “add liquidity only” or “ALO”) and the use of ISOs well beyond their intended purpose, as proposed by the rule filing. One relevant observation is that these two concerns are not unique to NYSE, as such features currently exist or have existed on other securities exchanges; however, as discussed below, this rule filing might be an outlier.

NYSE attempts to reclassify certain order types as order type “modifiers” or combinations of modifiers. The distinction between “order types” and “modifiers” is subjective, and it should not be used to mask true functionality or provide incomplete disclosure. What might be considered as a distinct “order type” by others (e.g., DAY ISO ALO) is presented by NYSE as a combination of modifiers. However, the whole may be different from the sum of its parts. The inherent properties of such modifiers may contradict each other or interact in a non-transparent and non-intuitive way, thus creating a lot of leeway for NYSE to decide on how such a combination might work or even allowing discretionary adjustments of this functionality from time to time. Accordingly, NYSE should bear the burden of documenting all material properties of such combinations and making appropriate disclosures to all market participants to account for the potential intended and “unintended” consequences.


5 Note, however, that this rule filing was picked up by the press. See Sam Mamudi, NYSE Order Revamp Seen Worsening Conflicts That Sprecher Decried, BLOOMBERG (Aug. 7, 2014), http://www.bloomberg.com/news/2014-08-06/nyse-order-revamp-seen-worsening-conflicts-that-sprecher-decried.html.
Of primary concern is that NYSE’s proposed implementation of the ALO functionality incorporates additional features that are traditionally of interest to high-frequency traders. Moreover, the ALO functionality, which permits traders to avoid executing in scenarios where they would have to pay taker fees, notably differs from the implementation of similar functionalities at other exchanges. The ALO functionality proposed by NYSE permits such orders to forward-tick price-slide in order to gain a superior queue position when a more aggressive price is permissible (e.g., the away market unlocks or a resting order on NYSE is canceled). The logic proposed in the forward-tick price-sliding feature of NYSE’s ALO amounts to little more than a reservation feature for queue priority that is not available to traditional orders, which normally incur taker fees in such scenarios. To be clear, the concept of queue priority referred to here is that NYSE’s ALO-designated orders would be able to be rebooked at top-of-queue coincident with top-of-book price changes in a manner that cannot be achieved by traditional order types. Thus NYSE’s ALO-designated order is not merely an order type to assist in managing maker-taker fees and rebates, but a powerful mechanism for “lighting up” at top-of-queue at an aggressive price on NYSE in a manner that is algorithmically managed by NYSE itself in a low-latency manner. Furthermore, NYSE’s ALO functionality offers this queue-priority perk while providing complete assurance that it captures rebates irrespective of price-aggressiveness (a feature that encourages users of the ALO functionality to enter orders with non-bona fide limit prices while they exploit this queue priority perk). This highly advantageous feature would undoubtedly be exploited within rebate arbitrage strategies employed by high-frequency traders.

Needless to say, NYSE’s ALO functionality appears primarily designed to provide queue-priority features that advantage ALO-designated orders over traditional orders. Such features should not be embedded in post-only order types, and, in fact, they have gradually been eliminated from major exchanges as a result of the order type controversy.\(^6\) Minimally, if NYSE aims to embed queue priority features in the ALO functionality, the exchange should be obligated to further disclose the major order interactions in which ALO-designated orders would reserve top-of-queue positions over other orders, which are often disadvantaged by paying taker fees in the exact conditions when ALO-designated orders reserve the top-of-queue position. To be clear, the burden should fall on NYSE to show that the ALO functionality does not amount to a discriminatory treatment of other order types in terms of securing a top-of-queue position. Are there cases of traditional limit orders arriving earlier in time being eligible to be booked with a higher priority at the prices for which the ALO functionality can reserve a superior queue position? If so, NYSE’s filing should clearly provide examples of all cases by which other order types can compete on a level playing field with the ALO’s reservation feature. If not, NYSE should provide further justification on how the introduction of this queue-priority reservation feature is warranted given its potential to reduce the execution quality for investors that generally post non-marketable limit orders.

Overall, while the ALO functionality does not appear to provide queue jumping features in relation to similarly priced orders that are "lit" at the same price, which has been permitted by certain order types operating on several securities exchanges,\(^7\) this functionality effectively serves as a queue priority feature offering a de facto reservation for a new price compared to other order types. This fact (or a refutation thereof) should be clearly disclosed by NYSE. Moreover, a natural question is whether this exclusive price reservation feature serves the broader goal of fair and orderly markets.

In stark contrast to NYSE’s implementation of the ALO functionality in a manner that embeds queue priority capabilities, NASDAQ took steps in 2012 to neutralize the usage of its Post-Only functionality as a mechanism for providing queue-priority advantages over other order types. For


\(^7\) For a discussion of such order types at other exchanges, see BODEK, supra note 1, at 33–37.
instance, NASDAQ’s price-slid orders, including Post-Only-designated orders would "not be guaranteed time priority over other incoming orders at the same price level."8 Furthermore, NASDAQ adopted the position that "Post-Only orders that are price slid because of NMS interaction and not because of their post-only instruction are eligible for automatic re-entry. Post-Only orders that are slid due to Post-Only restrictions will remain at their slid price."9 Hence, NASDAQ’s Post-Only functionality is prohibited from being ticked-forward into favorable queue positions in precisely the scenarios in which NYSE proposes it will support with its ALO functionality.

As discussed previously, NYSE’s ALO functionality is protected against being executed at aggressive prices, a feature that provides order discrimination and encourages non-bona fide orders (i.e., selling securities with a non-bona fide limit price that is priced at a significant percentage-point through the best bid or offer to ensure that such an order is posted at the most aggressive price). The fact that NYSE proposes to price-slide overly aggressive ALO-designated orders regardless of price-aggressiveness demonstrates an intent by NYSE to encourage the submission of limit prices that do not reflect the true economics of a security, and whose primary function appears to unfairly preference such orders for rebate capture at the most aggressive price permissible. This feature was eliminated on BATS in mid-2012 and most other major exchanges earlier to penalize such orders by subjecting them to taker fees. More specifically, the corresponding BATS filing made the following statement: "The Exchange proposes to modify the functionality of BATS Post Only Orders . . . to permit such orders to remove liquidity from the Exchange’s order book . . . if the value of price improvement associated with such execution equals or exceeds the sum of fees charged for such execution and the value of any rebate that would be provided if the order posted to the BATS Book and subsequently provided liquidity."10

Finally, in regard to the ALO functionality, NYSE proposes that such orders, when price-slid, should be implemented in a manner that allows a sophisticated trader to detect hidden orders by analyzing price-sliding confirmation messages, thereby contradicting the implicit representation by NYSE that a hidden order is in fact not detectable unless traded. Unlike its counterparts on other exchanges, the ALO functionality is permitted to forward-tick price-slide to establish prices when the hidden order on the contra side is canceled, thereby leaking information on this hidden order. NYSE provides no justification as to why an ALO-designated order should introduce a “loophole” that not only allows sophisticated firms to infer the existence of hidden orders resting on the book, but also provides the underlying non-public information on when such orders are modified or canceled.

Building upon the significant distortions embedded in NYSE’s ALO functionality, NYSE also seeks approval for the DAY ISO ALO, an advanced order type introduced by this filing. This order type, which has several inadequately documented counterparts on other exchanges, raises significant regulatory concerns, including compliance with Regulation NMS, as well as the feasibility of implementing this order type in a manner compliant with Regulation NMS. There are reasons to doubt that the proposed ALO designation for DAY ISOs complies with the requirements of Regulation NMS—or more specifically, the very definition of ISOs.11 Conceptually, it is unclear how a DAY ISO with the ALO designation can be used to “sweep” a locked market due to its ineligibility to “take” liquidity. This order type / modifier combination does not appear to satisfy the “routed to execute” requirement for sub-clause (ii) of the definition when considering the usage to fulfill the requirement to sweep away markets.

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8 NASDAQ’s Technical Update, supra note 6.

9 Id.


The same order type is also likely to be in conflict with Regulation NMS’s prohibition of crossed and locked markets. NYSE, with its proposal to accept a DAY ISO ALO at its aggressive limit price when such an order is non-marketable at the exchange, provides an environment that encourages high-frequency traders to post such orders aggressively with conditions likely to actually lock or appear to lock away markets. Such firms benefit from the protection against incurring taker fees and are able to leverage the self-determination properties to construct NBBO off fast data feeds to utilize such orders in a manner contradictory to the use of ISOS envisioned by Regulation NMS. NYSE is required by Regulation NMS to “[p]rohibit its members from engaging in a pattern or practice of displaying quotations that lock or cross any protected quotation in an NMS stock,” but exactly this behavior is encouraged by NYSE’s order type because it is designed to be accepted by the exchange at aggressive prices in conditions where high-frequency traders actually lock or cross away markets or appear to lock or cross away markets, thus defeating the intended purpose of ISOS to “routed to execute” in such conditions. Notwithstanding the potential scenario that NYSE’s implementation is a direct violation of Regulation NMS, it is unclear how NYSE could actually implement DAY ISO ALO orders in a manner that ensures NYSE’s duty to comply with Regulation NMS in a proactive manner, given that the exchange would have relinquished control over such orders and thus would accept DAY ISO ALO orders that lock or cross away markets that the exchange would normally reject in the course of fulfilling its obligation of prohibiting a pattern or practice of locking or crossing markets.

Importantly, the responsibility for complying with the provision of Regulation NMS requiring NYSE to prohibit a pattern or practice of locking or crossing markets is imposed on NYSE directly, but such compliance issues are not adequately addressed in the rule filing. NYSE does not explain how it will fulfill its obligation to comply with Regulation NMS, and particularly Rule 610 – a difficult prospect, given the properties of this order type. Moreover, the proposed rule change would conflict with other NYSE rules adopted pursuant to Regulation NMS and hence make NYSE’s rulebook self-contradictory, and NYSE would not be able to fully enforce this pivotal regulation. Similarly, NYSE provides no explanation as to how a member deploying DAY ISO ALO orders would comply with the definition of ISOS and the order protection mandate of Regulation NMS.

Notably, NYSE’s filing does not provide information on the purpose of this order type, the segment of the membership being accommodated, and the likely impact on traditional investors. Furthermore, NYSE itself recognized that ISOS on competing exchanges are not fully documented: “The rules of Nasdaq, BATS, BATS-Y, EDGA, and EDGX do not expressly provide that their versions of ISOS can be day, however, nor do their rules prohibit this functionality. In practice, Nasdaq, BATS, BATS-Y EDGA, and EDGX all accept ISOS with a day time-in-force condition.” This observation only strengthens the case for additional disclosure on DAY ISO ALO orders. Moreover, NYSE’s filing, while describing NYSE Arca’s PNP ISO order type as analogous, is in fact inconsistent with that order type or, even worse, offers evidence of undocumented features on NYSE Arca.

12 Id. at 37,631 (codified at Access to Quotations, 17 C.F.R. § 240.610(d)).

13 Id.


The likely usage of the proposed DAY ISO ALO would encourage individual market participants to needlessly cause violations of Regulation NMS, including Rules 610 and 611, as they jockey for superior queue position, and, in a practical sense, violate the NYSE rules adopted pursuant to Regulation NMS. Importantly, Regulation NMS requires every “trading center, broker, or dealer responsible for the routing of an intermarket sweep order take reasonable steps to establish that such order meets the requirements [of the ISO definition provided by Regulation NMS.]”16 In general, by using the ISO designation when sending their orders, market participants effectively undertake the obligation to comply with the very definition of ISO and its relevant characteristics. When a DAY ISO ALO is sent at the displayed price on NYSE and then price-slid due to its ALO modifier, its mechanism contradicts the purpose of the ISO designation as attesting to the purpose of sweeping protected quotations, (e.g., “routed to execute against the full displayed size”17). Some market participants planning to use this order type may believe that such use is permissible to protect from taking liquidity against hidden orders (which are not protected quotations per Regulation NMS).18 However, the definition of ISOs requires that displayed orders are swept when the ISO designation is used, a condition which this order type would not comply with and even obstruct. Moreover, this scenario would undoubtedly occur with great frequency, given NYSE’s design and typical strategies of high-frequency traders. There is no comparable version of the DAY ISO ALO offered by another exchange that addresses such issues in sufficient detail in order to determine whether its implementation is compliant with Regulation NMS.19 Needless to say, in the absence of any acceptable standard or norm, it is questionable whether such an order type could be used in any significant scale that would meet the compliance obligations of securities exchanges and market participants with regard to Regulation NMS.

To summarize, in most cases, DAY ISO ALOs would not be bona fide orders satisfying the ISO definition. In order to satisfy this definition, such orders would be required to be routed to execute as needed, be routed simultaneously with other bona fide ISOs, and, for practical purposes, comply with the

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16 Regulation NMS, 70 Fed. Reg. at 37,632 (codified at Order Protection Rule, 17 C.F.R. § 240.611(c)). In other words, this obligations is directly imposed on both trading venues and market participants.

17 Id. at 37,622 (codified at NMS Security Designation and Definitions, 17 C.F.R. § 240.600(b)(30)(ii)).

18 For instance, on LavaFlow ECN, which is an alternative trading system, the purpose of its DAY ISO Add Only order is described as “intended for those firms that utilize a fast market data feed and have already swept the market.” LavaFlow ECN, Initial Operation Report, Amendment to Initial Operation Report and Cessation of Operations Report for Alternative Trading Systems (Form ATS) Exh. F at 28 (Aug. 5, 2014), available at https://www.lavatrading.com/solutions/LavaFlow_Form_ATS.pdf [hereinafter LavaFlow’s Form ATS]. This statement implies that this order type is to be used outside of the conditions under which the ISO definition in Regulation NMS is satisfied, i.e., only after the market has been swept and non-simultaneously.

19 The extent of documentation of this order type on securities exchanges is essentially limited to its revocation as being redundant. More specifically, the Chicago Stock Exchange had revoked its Post Only ISO order type, which is somewhat similar to NYSE’s DAY ISO ALO, arguing that “a Post Only ISO is simply a limit order marked Post Only and BBO ISO.” Notice of Filing and Immediate Effectiveness of a Proposed Rule Change by Chicago Stock Exchange, Inc. to Consolidate All CHX Order Types, Modifiers, and Related Terms Under One Rule and to Clarify the Basic Requirements of All Orders Sent to the Matching System, Exchange Act Release No. 69,538, 78 Fed. Reg. 28,671, 28,673 (May 8, 2013). Interestingly, LavaFlow ECN has revealed the existence of not only a DAY ISO Add Only order type, but also a hidden version of that order type that may internally “lock[]/cross[] another displayed order.” LavaFlow’s Form ATS, supra note 18, Exh. F at 19. DCM maintains that regardless of the specificity of the underlying documentation, which should be fully disclosed in the first place, trading venues and their members are not relieved from complying with Rules 610 and 611 of Regulation NMS with respect to ISOs.
prohibition of a pattern or practice resulting in crossed or locked market. NYSE should demonstrate that such conditions would be satisfied or revise its proposal accordingly.

Rather surprisingly, NYSE’s rule filing contradicts the much-touted position of Jeffrey Sprecher, CEO of ICE, who, after acquiring NYSE, argued for the “simplification” of exchanges’ order type menus and criticized the connection between certain order types and the maker-taker pricing model. Importantly, the ALO functionality has a direct connection to the maker-taker pricing model because ALO-designated orders are set to execute only if they would collect rebates instead of incurring fees. In fact, Mr. Sprecher made the following statement this May:

[I]n order to protect market participants for regulatory breaches and while availing themselves of maker-taker rebates, execution venues have further complicated markets by creating order types that play into maker-taker capture such as the well-named “hide don’t slide” among others. . . . The New York Stock Exchange has a significant opportunity to offer solutions that rebuild confidence and protect shareholder value. And we believe that we can start by unilaterally reducing the excessive complexity that exists today, such as the proliferation of order types. Therefore, as a first step towards making our markets less complex, we will voluntarily reduce the number of order types at our U.S. equity exchanges. We’ve identified over one dozen existing order types that we plan to apply to the SEC for rule changes to eliminate. And beyond that, we will continue to evaluate our other order types to identify those that may not be providing the market with true utility.20

In another critique of the status quo, Mr. Sprecher made the following observation:

At the NYSE, we have as many as 80 different order types, most of which are there to make sure that somebody gets the right rebate or doesn’t breach Reg NMS as they’re trying to get a rebate, and don’t cause a locked market because they’re resting in a market with a high rebate, waiting for a trade to happen there, and that’d just added a lot of complexity to the marketplace.21

Furthermore, at a recent congressional hearing, NYSE announced a self-imposed “moratorium on any new, or novel, order types that further segment the market” and confirmed its intention of “the elimination of more than a dozen unique order types.”22 While the proposed DAY ISO ALO is not a “unique” order type in NYSE’s rulebook, its functionality is novel to NYSE. In fact, the proposed DAY ISO ALO belongs to the category of the most advanced order types in the arsenal of high-frequency traders, and, traditionally, this category of order types has lacked transparency.

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In conclusion, NYSE’s filing not only seeks to maintain the status quo, but to return to a time prior to 2012, when little attention was paid to the harmful impact of order handling of advanced order types on investors. NYSE’s filing introduces features that NASDAQ and BATS neutralized in 2012 amidst regulatory scrutiny. NYSE should provide clear and compelling evidence that its proposal would benefit securities markets and the investing public. NYSE should also provide order handling comparisons with common order types to show how traditional limit orders and hidden orders are disadvantaged by the features discussed above. NYSE’s submission is of concern to the problem of equity market structure as it will create precedent on the issues disclosed, many of which could harm the marketplace as a whole by continuing to provide features that are tuned to the needs of high-volume / low-latency traders.

We appreciate your consideration of our comments. We will make ourselves available at your convenience to discuss the issues raised. Please do not hesitate to contact me at (203) 359-2625 or haim@haimbodek.com.

Sincerely,

Haim Bodek
Managing Principal
Decimus Capital Markets, LLC