citi

December 22, 2014

Via Electronic Mail (rule-comments@sec.gov)

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

Re: Comments on Proposed National Market System Plan to Implement a Tick Size Pilot Program on a One-Year Pilot Basis (Release No. 73511; File No. 4-657)

Dear Secretary:

Citigroup Global Markets Inc. ("CGMI") and its affiliates, Automated Trading Desk Financial Services, LLC ("ATD"), LavaFlow, Inc. ("FLOW") and Citigroup Derivatives Markets Inc. ("CDMI" and, together with CGMI, ATD and FLOW, "Citi")[1] appreciate the opportunity to comment on the above-referenced Tick Size Pilot Program (the "Release") issued by the U.S. Securities and Exchange Commission (the "SEC" or "Commission") on November 3, 2014. This is the second comment letter that Citi has submitted on the Tick Size Pilot Program.[2] In fact, we were pleased to see that many of our previous recommendations were incorporated in the Release and thank the Commission for its consideration.

As stated in Citi's First Comment Letter on the Tick Size Pilot Program, we generally support the adoption of a pilot program to widen tick sizes in certain securities. That said, it is our view that the proposed National Market System Plan filed by the self-

[1] Citigroup Inc. is a diversified global financial services holding company whose businesses provide a broad range of financial services to consumer and corporate clients as well as governments and other institutions. Citi has some 200 million client accounts and does business in more than 100 countries. Citi's primary U.S. broker-dealer subsidiary, Citigroup Global Markets Inc., is registered as a broker-dealer in all 50 states, the District of Columbia, Puerto Rico, Taiwan and Guam, and is also a primary dealer in U.S. Treasury securities and a member of the principal United States futures exchanges. Other Citi affiliates actively engaged in U.S. equity market trading include Automated Trading Desk Financial Services, LLC (ATD) and LavaFlow, Inc. Citigroup Derivatives Markets Inc. is actively engaged in U.S. options market making. Additional information may be found at www.citigroup.com or www.citi.com.

[2] *See* Letter from Daniel Keegan, Managing Director, Citigroup Global Markets Inc. (October 22, 2013), available at http://www.sec.gov/comments/4-657/4657-24.pdf ("Citi's First Comment Letter on the Tick Size Pilot Program").

regulatory organizations ("SROs") on August 25, 2014 (the "NMS Plan"), exceeds the scope of the SEC Order filed on June 24, 2014 (the "Order"),[3] in several key areas.

THE ONEROUS TRADE-AT RESTRICTIONS IN TEST GROUP THREE INTRODUCE UNDUE OPERATIONAL AND SYSTEMIC RISK AND MAY THREATEN THE INTERGRITY OF THE DATA

As currently drafted, Test Group Three of the NMS Plan includes a trade-at restriction. Citi has long opposed any form of a trade-at rule.[4] That said, while we have never been in favor of a trade-at rule, we are not necessarily opposed to the inclusion of a trade-at restriction in this pilot program if the Commission believes that it would provide valuable empirical data to analyze the potential positive or negative impacts of such a trade-at restriction. However, the NMS Plan's version of the trade-at restriction should be more narrowly tailored to achieve the objectives of the pilot.

For example, the version of trade-at included in the NMS Plan was expanded to protect top of book quotes at every exchange, not just quotes at the National Best Bid or Offer ("NBBO"). In addition, the version of trade-at included in the NMS Plan also expands protection to equal quotes as well as better quotes, which we believe to be a significant change to Regulation NMS.

Further, the SROs drafted the NMS Plan to allow for internalization "but only up to the amount of [a market participant's] displayed size." This is more onerous than any version of a trade-at restriction that we have ever heard discussed.

Citing Example 3 in the NMS Plan: a market participant that is displaying 100 shares at the NBBO would, under this construct of a trade-at rule, be permitted to "internalize" only after routing 100 shares to the venue where it is quoting the 100 shares. This is not actually internalization; it is simply providing the quoting exchange with volume (i.e., revenue) that would not otherwise trade there. In this restrictive construct of trade-at, there is no real benefit to price discovery and no real benefit to the displayed order; therefore, there is no incentive for market participants to display additional liquidity. It is simply a way to subsidize the for-profit exchanges by forcing more orders to be routed to them.

---

[3] *See* http://www.sec.gov/rules/other/2014/34-72460.pdf.

[4] *See* Letter from Daniel Keegan, Managing Director, Citigroup Global Markets Inc. (May 5, 2010), available at http://www.sec.gov/comments/s7-02-10/s70210-174.pdf ("Citi's First Comment Letter on the SEC Concept Release on Equity Market Structure") (see discussion of trade-at on pages 4-5); *see also* Letter from Daniel Keegan, Managing Director, Citigroup Global Markets Inc. (August 7, 2014), available at http://www.sec.gov/comments/s7-02-10/s70210-416.pdf ("Citi's Second Comment Letter on the SEC Concept Release on Equity Market Structure") (see discussion of trade-at on pages 6-7).

Carrying the example further: even after the market participant routes to the venue where it is quoting, it is permitted to truly internalize order flow only up to the amount of its displayed size (here, 100 shares), rather than the full 700-share order. The balance of such order (i.e., 600 shares) would then need to be routed back to each other market center and potentially execute against any displayed liquidity at such market centers. Any unexecuted portion of that order would then be re-routed back to the original market participant, who could then internalize again "only up to the size of its displayed liquidity."

There are many issues with imposing this size restriction on a market participant's ability to internalize order flow. Practically speaking, there is greater risk of information leakage and adverse market impact on customers' orders by requiring their brokers to display in greater size. Considering that the average trading size in today's market is approximately 200 shares, the posting of 200 shares is typically sufficient to represent true trading interest. Any requirement to post more than 200 shares constitutes a greater chance of information leakage.

In addition, requiring market makers to display in significant size changes their risk profile; in order to offset that heightened risk, market makers would likely be forced to further widen spreads, beyond the already wider tick size increments called for in this pilot program. Instead, if market makers were permitted to internalize up to the full size of the incoming order (provided that such market maker is displaying liquidity at the NBBO in any size), this would incentivize market makers to display at the NBBO more often, which is one of the goals of the tick size pilot program. From a policy perspective, Citi supports incentives to display more liquidity without measures that are likely to unnecessarily widen spreads further.[5]

From an operational standpoint, this overly restrictive interpretation of trade-at requires a very complex system of networking and byzantine routing rules with orders passing back and forth among all market participants, which is problematic at all times and especially so in quickly moving markets. The end result is an unnecessary level of systems and programming work and the introduction of an unacceptable level of systemic risk, designed to accommodate one segment of market participants (the for-profit exchanges) over all others. This places many market participants in the unenviable position of having to choose whether to program for Test Group Three – and incur a dangerous level of operational and systemic risk for a relatively small basket of 400 securities that trade relatively infrequently – or instead to opt not to trade those securities

[5] Also, the exchanges have suggested an exception to the trade-at restriction to allow for processing of ISO orders. Presumably, this exception was included to permit exchanges to continue processing ISO orders without changes to their matching systems. However, if market participants find the trade-at restriction to be overly prescriptive, this exception might be used to avoid the rule altogether. Including a broader segment of the industry in the formulation of the NMS Plan would likely avoid such an unusual result (see our discussion below under "SRO Governance and Rulemaking Issues").

at all for the duration of the pilot program (opting to route away as agent instead). If a significant number of market participants make a rational decision to opt for the latter, it would threaten the integrity of the empirical data that the tick size pilot program is intended to generate.

This result is avoidable. In fact, the overwhelming majority of overall costs of this pilot program can be attributed to Test Group Three and the trade-at restriction in particular. To bring the costs of the pilot program more in line with the potential benefit to investors, the trade-at restriction could be removed altogether, or modified in several ways: (1) eliminate the size restriction – in other words, allow for internalization up to the full size of the order, provided that a market participant is displaying liquidity at the NBBO in any size; (2) remove the requirement for a market participant to first take out the quote on the exchange where they have displayed their quote at the NBBO; and (3) limit trade-at to the protection of the best protected quote only, rather than all protected quotes.

METRICS

In Citi's First Comment Letter on the Tick Size Pilot Program, we argued that enhanced liquidity for the pilot securities ought to be the appropriate metric, rather than focusing on more indirect, longer-term goals such as proliferation of research or more initial public offerings. The most tangible metrics to measure enhanced liquidity, we argued, include the size of quotes/orders available at the NBBO, as well as the amount of overall trading which occurs in the security (corrected for overall market share variances during the period of the pilot versus the comparison period). In addition, we would look to other measures such as average trade size (which we would expect to increase as liquidity is concentrated at wider increments) and intraday volatility (which we expect to dampen as the market offers more liquidity at each price point). Finally, we would add that relevant metrics should include quote durations and fill rates, both of which we would expect to increase.

Instead, the NMS Plan seems to equate overall trading with on-exchange displayed liquidity, even though they are not the same thing. If a particular pilot security trades more volume because of its wider tick increment, we believe that to be a successful outcome, regardless of whether that increased volume occurs on or off exchange. In our view, the pilot is seeking to determine how to deepen and enhance liquidity for a particular segment of the overall market, not just increasing the market share of one segment of market participants at the expense of others.

Further, the NMS plan includes "market maker profitability" as a metric of success. We do not believe this to be appropriate for two reasons. First, measuring a market maker's profitability on a symbol-by-symbol basis is neither feasible nor accurate. Profitability is a measure of revenue vs. cost, and costs are typically allocated to trading across the board, rather than on a symbol-by-symbol basis. Second, it seems wholly inappropriate for one segment of market participant (the for-profit exchanges) to regulatorily require disclosure of the profitability of their primary competitors (market makers and broker-dealers). This is consistent with the SRO Governance and Rulemaking issues that we discussed in previous comment letters, and which we explore further in the section below.

While we remain opposed to the production of this proprietary profitability data for the reasons stated above, if it is required in any event, we think that it should be produced solely for the SEC and in any event not published to a primary competitor of the market makers.

SRO GOVERNANCE AND RULEMAKING ISSUES

Citi has previously argued, along with several industry associations, that SRO Governance is in need of reform to keep pace with the commercial reality that exchanges have long since been demutualized and are now for-profit corporations that answer to shareholders rather than the general public.[6] As a result, it is no longer appropriate for the SROs to exclusively determine the scope of rules that apply to all segments of market participants, including the direct competitors of the for-profit exchanges themselves.

In this instance, the rule establishing a tick size pilot program should not be an NMS Plan. As constructed, major market participants were not engaged in the design of the Plan, and those who were involved are competitors of one another and of the other market participants who are subject to the Plan. Instead, the SEC ought to engage in its own full rulemaking process, rather than ordering the SROs to develop their own NMS Plan.[7] At a minimum, if this pilot program must be an NMS Plan, the brokerage community should be granted representation on this Plan Committee. Both Citi and SIFMA have been making this argument for years, and this pilot program is a prime example of where such involvement is not only entirely appropriate, but would be beneficial to the process overall.

Without brokerage representation on this Plan Committee, we have seen how the SROs indeed draft such proposals in a way that benefits their business model over their competitors (see above discussion of the trade-at restriction). As previously mentioned,

[6] *See* Citi's Second Comment Letter on the SEC Concept Release on Equity Market Structure; *see also* Letter from Daniel Keegan, Managing Director, Citigroup Global Markets Inc. on NASDAQ's mishandling of the Facebook IPO (August 22, 2012), available at http://www.sec.gov/comments/sr-nasdaq-2012-090/nasdaq2012090-5.pdf. *Further see* Letter from Theodore R. Lazo, Managing Director and Associate General Counsel, SIFMA on the Self-Regulatory Structure of the Securities Markets, available at http://www.sifma.org/issues/item.aspx?id=8589944673.

[7] *See* Letter from Rep. Sean P. Duffy (WI-07), U.S. House of Representatives, on the Plan to Implement a Tick Size Pilot Program (November 17, 2014), available at http://www.sec.gov/comments/4-657/4657-43.pdf ("Engaging in a rule-making process would have allowed all interested parties to contribute to the Plan's draft development, instead of a few.").

while Citi certainly does not favor a trade-at rule, we are not necessarily opposed to the inclusion of a trade-at restriction in this pilot program if the Commission believes that it would provide valuable empirical data to analyze the potential positive or negative impacts of such a trade-at restriction. We simply ask that it be a fair and balanced version of a trade-at rule, rather than one so onerous from an implementation perspective that it actually threatens the integrity of the data that the pilot will generate while adding undue costs on all market participants. With fair representation on this Plan Committee, the brokerage community would be able to help the SROs shape a more fair, reasonable and nuanced approach, along the lines of our above recommendations.

One final recommendation that we would like to make is to exempt opening and closing auctions from any aspect of the trade-at pilot program. We and other firms guarantee opening and closing prices. If we are suddenly required to "satisfy" the book at the touch because we are pricing such orders based on the opening or closing print, this service will certainly be detrimentally impacted. An exemption is therefore necessary to avoid this outcome.

We are hopeful that the comments we have made in this letter can assist the Commission in its thinking about the proposed tick size pilot program.

*　*　*　*　*

CONCLUSION

We sincerely appreciate the opportunity to comment on equity market structure issues, and we welcome feedback from all market participants on our above recommendations. Citi looks forward to discussing these matters further with the Commission and its staff. If you have any comments or questions, please do not hesitate to contact me at 212.723.9092 or daniel.keegan@citi.com.

Sincerely,

Daniel Keegan
Managing Director,
Head of Equities for the Americas

cc: The Honorable Mary Jo White, Chair
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner
Stephen Luparello, Director, Division of Trading and Markets
David Shillman, Associate Director, Division of Trading and Markets
Heather Seidel, Associate Director, Division of Trading and Markets
Michael Gaw, Assistant Director, Division of Trading and Markets
Daniel M. Gray, Senior Special Counsel, Division of Trading and Markets
Theodore Venuti, Senior Special Counsel, Division of Trading and Markets
Gregg E. Berman, Associate Director, Office of Analytics and Research
Craig M. Lewis, Director and Chief Economist, Division of Economic and Risk Analysis
Amy K. Edwards, Assistant Director, Division of Economic and Risk Analysis