CITADEL | Securities

April 26, 2019

Mr. Eduardo A. Aleman
Deputy Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549–1090

Re: EDGX Retail Priority Proposal (File No. SR-CboeEDGX-2019-012)

Dear Mr. Aleman:

Citadel Securities[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") on the proposal by Cboe EDGX Exchange, Inc. ("EDGX") to introduce order book priority for "Retail Orders" (the "Proposal").[2] Under the Proposal, an order designated as a "Retail Order" will receive higher queue priority in the order book than other displayed orders at the same price. We are concerned that the Proposal does not adequately distinguish retail investors' orders from active professional traders' orders – and that inadvertently granting queue priority to certain active professional traders' orders will impair market quality, institutional investor fill rates, and the provision of displayed liquidity. We therefore urge EDGX to revise the Proposal to more narrowly tailor its application and believe this should be a prerequisite to Commission approval. We further ask the Commission to explore better methods of delineating between retail and professional customers in the context of this and other exchange programs and proposals going forward.

Executive Summary

As the leading destination for retail order execution, we are committed to the quality of execution for retail investors. Current U.S. equity market structure has unleashed an enormous amount of competition and innovation that has greatly benefited retail investors through better

[1] Citadel Securities is a leading global market maker across a broad array of fixed income and equity securities. In partnering with us, our clients, including asset managers, banks, broker-dealers, hedge funds, government agencies and public pension programs, are better positioned to meet their investment goals. On an average day, Citadel accounts for approximately 21 percent of U.S. listed equity volume, 23 percent of U.S. listed equity option volume, and more than 39 percent of all retail U.S. listed equity volume.

[2] 84 FR 13729 (April 5, 2019), available at: https://www.govinfo.gov/content/pkg/FR-2019-04-05/pdf/2019-06720.pdf.

pricing, lower trading costs and increased market transparency. Retail investors today benefit from substantial price improvement,[3] size improvement,[4] and fill-rate improvement.[5]

We welcome market innovations that improve execution quality for bona fide retail orders provided they do not otherwise have a substantial adverse impact on market quality and integrity. However, based on past experience in both the equity and options markets, we do not believe that this Proposal meets that criteria.

The Proposal leverages the same definition of "Retail Order" that is used in various exchange Retail Liquidity Programs ("RLPs") – a definition that does not adequately distinguish retail investors' orders from active professional traders' orders. The Proposal would therefore also grant queue priority to certain active professional traders, and thereby encourage more active professional trading through "Retail Orders". Such active professional traders could more easily implement spread capture models by simply trading back-and-forth at the top of the queue. The loss of queue priority for all other market participants will undermine the intended benefits for bona fide retail investors, adversely affect fill rates for institutional investors' limit orders, and impair the provision of liquidity by market makers. We do not believe providing queue-prioritization to trading strategies executed by certain active professional traders – at the expense of bona fide retail investors, institutional investors and market makers – is beneficial to the market. It is also not consistent with Proposal's stated goal to "improve market structure in ways that facilitate ordinary investors achieving their investment goals."

To minimize any adverse impacts on market quality and integrity, the Proposal should be amended to more narrowly focus on retail investors' orders, and by extension, to avoid granting queue priority to certain active professional traders' orders. The options market encountered and solved an analogous issue through the introduction of a definition to distinguish "professional customers" from retail customers. A similar solution is warranted in the context of the Proposal and other exchange programs going forward.

Lessons from Retail Liquidity Programs

The market's experience with RLPs evidences the failure of an overly broad definition of "Retail Order". RLPs have not gained traction in the market,[6] precisely because the RLP definition of "Retail Order" includes orders from both retail investors as well as active professional traders. To the extent that the "Retail Order" flow routed to RLP programs includes orders from active

[3] Retail investor orders typically receive prices that are better than publicly-quoted prices (data from 605 disclosures shows average price improvements typically exceed one-half penny, or 50 mils).

[4] Large orders by retail investors may be fully filled at the publicly quoted price even when such orders are much larger than the aggregate publicly quoted size across all exchanges.

[5] Non-marketable limit orders placed by retail investors may be filled (in whole or in part) at an amount that exceeds the number of shares traded across all exchanges while the order was in force.

[6] Evidence from one exchange's RLP shows that it "has not generated significant activity … and has accounted for less than 0.1% of" consolidated volume while fill rates generally ranged between 15% to 25%. *See* https://www.sec.gov/rules/sro/nyse/2019/34-85160.pdf at pages 19-20 and 24.

professional traders and is thus not as attractive to other market participants, those market participants will simply elect not to post RLP liquidity and fill-rates for RLP routes will be low. The market's experience with RLPs thus demonstrates the importance of correctly defining "Retail Orders", as an overly broad definition continues to undermine the RLPs even as their additional complexity lingers in the market.

The adverse market impact of an overly broad definition of "Retail Order" will be more significant under the Proposal than it is in the RLP context. As noted above, in the RLP context, the overly broad definition of "Retail Order" has effectively constrained their relevance in the market. In contrast, there is no similar constraining force under the Proposal since all "Retail Orders" will automatically impact the entire EDGX order book by reducing the relative priority of bona fide retail orders, institutional orders and market maker quotes. Appropriately calibrating the definition of "Retail Order" is therefore critically important under the Proposal, given its potential impact on the NBBO, on the intended retail investor beneficiaries, on institutional investors, on market makers, and on market quality and liquidity more broadly.

Lessons from the Options Market

Options exchanges have historically granted priority to orders entered on behalf of non-broker dealer retail customers, as noted in the Proposal.[7] However, in order to target this benefit to non-professional retail investors, options exchanges implemented a "professional customer" definition in order to prevent order priority from being granted to traders who engage in a significant amount of daily trading activity.[8] In the options market, a "professional customer" is defined as a trader who places more than 390 orders in listed options per day on average during a calendar month for their own beneficial account.[9]

The same order-priority issues and concerns that led the options markets to adopt the concept of a "professional customer" apply in the context of the Proposal. Therefore, a similar solution is warranted to mitigate the risks and adverse consequences of having the prioritization benefits EDGX is proposing to offer retail investors exploited by active professional traders at the expense of bona fide retail investors, institutional investors, and market makers.

The options markets use a simple threshold of 390 orders or more per day to distinguish professional customers from retail customers – and a similar orders or trades per day metric would be suitable for use in the equities markets. This could be complemented by a regime for self-certification of customer status. We recommend that the Commission explore criteria that would

[7] Proposal at 13732.

[8] We note that when customer priorities were first implemented by the options exchanges, there was not a separate "professional customer" category. However, in 2009 the SEC approved rule proposals by both ISE and CBOE to adopt this additional category for many of the reasons explained above. See Securities and Exchange Release No. 34-59287; File No. SR-ISE-2006-26, Jan 23, 2009 (https://www.sec.gov/rules/sro/ise/2009/34-59287.pdf) and Securities and Exchange Release No. 34-61198; File No. SR-CBOE-2009-078, Dec 17, 2009 (https://www.sec.gov/rules/sro/cboe/2009/34-61198.pdf).

[9] *See* Proposal at 13732, FN 31.

be most useful in distinguishing professional customers from retail customers in the equity markets for the purpose of the Proposal and any other similar mechanisms that may be proposed in the future.

True Impact of the Proposal

Unless permitted by an exception,[10] all retail non-marketable limit orders are already posted for display on one or more exchanges. Since non-block retail limit orders are already displayed on exchange, the impact of the Proposal is not to increase the number of displayed orders, but instead to potentially modify the queue priority given to those displayed orders. As such, the Proposal is not likely to yield any benefits to overall market quality through improvements to price discovery or by providing new opportunities for market participants to interact with retail non-marketable limit orders. Instead, the Proposal is more likely to simply bias the existing exchange display of retail non-marketable limit orders towards EDGX versus other exchanges. The limited benefits of the Proposal should thus be weighed against its potential to complicate market structure more broadly.

Conclusion

To the extent EDGX declines to adopt a "professional customer" definition for purposes of the Proposal – and the Commission approves the Proposal as is – certain active professional traders will obtain a competitive advantage over other market participants, including retail investors, institutional investors and market makers. If orders from active professional traders can jump other resting orders in queue priority at any moment, institutional investor fill rates may be negatively impacted and liquidity conditions may deteriorate, as the complexity and risks associated with providing liquidity will increase. These concerns would be exacerbated to the extent other exchanges were to adopt similarly expansive order priority proposals.

In light of these concerns, we urge EDGX to adopt a "professional customer" definition in order to more narrowly-tailor the Proposal and as a precondition to Commission approval. We further believe that the Commission should explore better methods of delineating between retail and professional customers in the context of this and other exchange programs and proposals.

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We appreciate the opportunity to provide comments on the Proposal. Please feel free to call the undersigned at [redacted] with any questions regarding these comments.

Respectfully,

/s/ Stephen John Berger

Global Head of Government & Regulatory Policy

[10] For example, see the block-size exception to Rule 604.