CITADEL | Securities

December 27, 2016

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549–1090

Re: Proposed Nasdaq New Extended Life Priority Order Attribute (Release No. 34-79428; File No. SR-NASDAQ-2016-161)

Dear Mr. Fields:

Citadel Securities ("Citadel")[1] appreciates the opportunity to comment on Nasdaq Stock Market LLC's ("Nasdaq") proposal to create a new "Extended Life Priority Order Attribute" (the "ELO Attribute").[2] Nasdaq proposes that orders with this ELO Attribute ("ELO Orders") will receive higher priority than other displayed orders at the same price.[3] Citadel urges the Securities and Exchange Commission (the "Commission") to disapprove the Proposal because it is inconsistent with the requirements of the Securities Exchange Act of 1934 (the "Exchange Act") and the rules thereunder.

I. The Proposal Is Not Solving an Identified Problem

Nasdaq's rationale for proposing the ELO Attribute is that retail investors are experiencing difficulties in obtaining fills for non-marketable limit orders under the current market structure. The initial proposed roll-out of the ELO Attribute would only apply to "Designated Retail Orders", purportedly to provide retail investors with "opportunities to participate passively at the prevailing market when transactions occur."[4] Based on market statistics and our experience as a leading destination for retail order execution, however, Nasdaq's rationale is factually inaccurate.

When retail investors submit non-marketable limit orders, such orders are executed whenever prices move during the day so that the orders become marketable—except in very limited circumstances.[5] Our internal data shows that, for retail non-marketable limit orders that become marketable during the day and which are not otherwise cancelled, the fill rate is over 95%.

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[1] Citadel Securities is a leading global market maker across a broad array of equity and fixed income 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 15 percent of U.S. listed equity volume, 19 percent of U.S. listed equity option volume, and more than 35 percent of all retail U.S. listed equity volume.

[2] Securities Exchange Act Release No. 79428 (Nov. 30, 2016), 81 FR 87628 (December 5, 2016), available at: https://www.gpo.gov/fdsys/pkg/FR-2016-12-05/pdf/2016-29116.pdf (the "Proposal").

[3] Proposal at 87629.

[4] *Id.* at 87629-30.

[5] One example of the very limited circumstances when an execution may not occur is where a resting retail limit order is priced at what turns out to be exactly the high (or low) of the day, and only a few shares trade at that

Nasdaq offers no evidence that retail investors are experiencing difficulty in obtaining fills for resting orders and therefore would benefit from a special order priority status. In our view, the Commission should require substantial evidence demonstrating a real problem before permitting an exchange to introduce a new order attribute and new rules that create a drastic departure from the fundamental norms of current equity market structure.

II. The Proposal Is Fundamentally at Odds with FINRA Rule 5320

The intersection of FINRA Rule 5320 and the Proposal raises serious questions about the workability of the Proposal and places an undue burden on competition, in contravention of Section 6(b)(8) of the Exchange Act.

FINRA Rule 5320 states that "a member that accepts and holds an order in an equity security from its own customer or a customer of another broker-dealer without immediately executing the order is prohibited from trading that security on the same side of the market for its own account at a price that would satisfy the customer order, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account."

FINRA Rule 5320 obliges a broker-dealer to fill held customer orders in certain circumstances that may well occur within one second of receiving a customer limit order. However, when the firm does so, it also must cancel the customer's resting order to prevent the customer from being filled twice. For example, if a broker-dealer has routed a customer ELO Order to Nasdaq, but is required to pull that ELO Order within one second and fill it to comply with its obligations under FINRA Rule 5320, that apparent cancelation of the ELO Order will negatively impact the percentage of that broker-dealer's ELO Orders that meet the one second minimum life. In very liquid stocks, we expect this fact pattern to occur frequently. The clear obligations of FINRA Rule 5320 seem to be at odds with the intent of the Proposal which seeks to demand a minimum resting time for ELO Orders of one or more seconds.

We note that these issues even impact customers that do not generally seek to place non-marketable limit orders. For example, when a customer's marketable limit order is not fully executed, the unexecuted portion will be displayed as a non-marketable limit order, typically at the top of the book (and with queue priority). If a broker-dealer cannot meet the 99% threshold due to its FINRA Rule 5320 obligations discussed above, that broker-dealer's customer limit orders (which cannot avail themselves of ELO) will be disadvantaged as compared to other broker-dealers' retail customer limit orders.

Given the above, the Proposal is unfairly discriminatory towards, and places an undue competitive burden on, wholesale broker-dealers, given the role they play in the execution of retail customer orders. Rather than solving any problems that retail investors face in getting their limit orders filled, the Proposal seems squarely aimed at wresting retail order flow away from wholesale broker-dealers by regulatory fiat for the benefit of Nasdaq stakeholders, while at the same time adversely impacting countless retail and institutional orders.

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specific price. By contrast, the fill rate is 100% if a stock trades at a price higher than the limit price on a resting sell order or at a price lower than the limit price on a resting buy order.

III. The ELO Attribute Will Negatively Impact Market Liquidity, Competition, and Fairness

A. Liquidity Providers Rely on Price/Time Priority

If the Proposal goes into effect, market participants that are ineligible to, or choose not to, use the ELO Attribute will no longer have certainty regarding the priority of their resting orders on Nasdaq. Specifically, as proposed, at any given time, an ELO Order may be placed at the same price as, and then jump ahead of, other displayed orders already placed on the exchange (including orders on behalf of retail investors placed by a broker-dealer uncomfortable making Nasdaq's attestation). This fundamental change to the well-established principle of price/time priority can be expected to negatively impact market liquidity for several reasons.[6]

First, liquidity providers will be required to address the possibility that their orders will be jumped in priority at any moment, and particularly at times when it is the most beneficial to be at the top of the queue. As a result, the complexity and risks associated with providing liquidity will increase, potentially resulting in wider spreads that will adversely impact all institutional and retail investors.

Second, the removal of price/time priority will impact the ability of liquidity providers to reliably hedge. For example, the efficient functioning of the ETF market is predicated on the ability of market makers to hedge with the underlying securities. Hedging keeps the prices of ETFs and their underlying securities aligned, strengthening the resiliency of the market.[7] But once uncertainty regarding the queue priority of resting orders in the underlying securities of an ETF is introduced, market makers can no longer assess with the same certainty whether their orders are likely to be executed. This will impact hedging strategies in ETFs and their underlying securities and will make liquidity provision more challenging and expensive. The associated increase in risks and costs will be borne by institutional and retail investors.

Given the above, the Proposal's removal of price/time priority does not appear to protect investors or be in the public interest, as required by Section 6(b)(5) of the Exchange Act. Even

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[6] We are aware that alternatives to the principle of price/time priority already exist, however, none pose the same issues as the Proposal. With respect to Nasdaq PSX's pro-rata priority structure, while resting orders are filled pro-rata based on size, all market participants are treated fairly and equally, and there is no ability to jump in front of others in the queue. With respect to NYSE RLP, price/time priority is still respected – RLP orders get priority but that is because they are executed at a better price. In sum, on price/time priority equity exchanges, there is generally no way to lose queue position to another quote that arrived after your quote and is at the same price. Finally, given the relative volumes transacted on Nasdaq as compared to on Nasdaq PSX or NYSE RLP, the risk of adversely impacting overall market quality is far more significant.

[7] *See, e.g.,* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule, 79 FR 5536, 5608 (Jan. 31, 2014) ("Some firms, whether or not an [authorized participant] in a given ETF, may also actively engage in buying and selling shares of an ETF and its underlying instruments in the market to maintain price continuity between the ETF and its underlying instruments, which are exchangeable for one another. Sometimes these firms will register as market makers on an exchange for a given ETF, but other times they may not register as market maker. Regardless of whether or not the firm is registered as a market maker on any given exchange, this activity not only provides liquidity for ETFs, but also, and very importantly, helps keep the market price of an ETF in line with the NAV of the fund.").

Nasdaq acknowledges that the current market structure, and its reliance on price/time priority for managing displayed orders, has led to increased competition, smaller bid/offer spreads, lower trading costs, and fairer access to markets.[8] In contrast, this Proposal can be expected to negatively impact market liquidity, to the detriment of all investors.

B. The ELO Attribute Will Unfairly Burden Market Competition

Nasdaq proposes to make the ELO Attribute available only for "Designated Retail Orders" in the initial roll-out. Nasdaq attempts to justify providing certain orders with a specific structural advantage by:

- Likening the priority that will be accorded to ELO Orders to other permitted "incentives in the form of reduced fees and rebates"; and
- Asserting that market participants can avoid Nasdaq's market and trade on "competing venues if they deem participation in Nasdaq's market is no longer desirable"[9].

These arguments do not hold up to scrutiny.

First, this Proposal is quite different than fee and rebate incentives granted by exchanges to market participants, such as when a market participant has favorable economic incentives for establishing the NBBO.[10] These incentive programs are available to all members and do not fundamentally alter how orders interact in the market. In contrast, the ELO Attribute would only be available for a subset of market participants but would adversely and materially impact all other market participants. Exchanges should seek to compete for order flow based on the quality of services provided, not by creating order attributes inappropriately favoring certain market participants at the expense of others.

Second, asserting that market participants "can readily choose between competing venues if they deem participation in Nasdaq's market is no longer desirable"[11] is inaccurate. Under Reg NMS, if Nasdaq is displaying a protected quote at the NBBO, market participants must at least match that price on other trading centers or route to execute on Nasdaq. There is not a choice to simply ignore or "opt out" of routing orders to Nasdaq.

Third, Nasdaq fails to explain how it will prevent professional traders from also utilizing the ELO Attribute immediately in order to obtain a competitive advantage over other market participants. The Proposal only requires exchange members to attest that "substantially all" orders labeled as "Designated Retail Orders" qualify for this designation.[12] In addition, Nasdaq suggests that it will only monitor actual use of the ELO Attribute on a "quarter-by-quarter basis".[13]

[8] Proposal at 87629.

[9] *Id.* at 87631-32.

[10] *See id.*, at 87631.

[11] *Id.* at 87632.

[12] *Id.* at 87630 FN 15.

[13] *Id.* at 87630.

Experience has repeatedly shown that professional traders will masquerade as retail investors to obtain a competitive advantage. For example, the equity options market struggled with how to prevent professional traders from taking advantage of customer priority rules that were specifically designed for retail investors, and have attempted to implement solutions such as crafting "professional customer" designations.[14]

For the reasons above, we urge the Commission to find that the Proposal unduly burdens competition, as prohibited by Section 6(b)(8) of the Exchange Act.

C. The ELO Attribute May Raise Fairness Concerns for Retail Investors

Increasing the complexity of equity market structure by implementing new order types that fundamentally change current market practice can undermine investor confidence in markets and lead to concerns about fairness.[15] Nasdaq's Proposal to give priority to ELO Orders is the latest example of this complexity and may lead to unexpected outcomes for market participants.

For example, Nasdaq will be disclosing through its data feeds which orders are utilizing the ELO Attribute.[16] As a result, retail investors may actually be disadvantaged by using the ELO Attribute, since other market participants will know which orders are ELO Orders required to remain unmodified for at least one second.[17] This information leakage may adversely affect the execution quality for those orders.

In addition, retail investors not utilizing the ELO Attribute may be surprised to learn that their resting orders can be jumped throughout the day, including by professional traders masquerading as retail investors, even if they placed an order that formed a new best bid or best offer. Dynamics such as this raise genuine concerns about market integrity and fairness.

Finally, the 99% requirement creates a potential dilemma for members who receive a sub-one-second cancelation from a customer. By processing this cancelation in accordance with its customer's specific instructions, the member may fall under the 99% threshold which could deprive many of its other customers from ELO Order status in subsequent quarters. However, since customers are not explicitly electing to use or not use an ELO Order (and may not even be aware of its existence), there is no basis to deny the customer's immediate cancelation request.

[14] *See, e.g.*, Securities Exchange Act Release No. 59287 (January 23, 2009) (granting approval of ISE's proposal to adopt a "Professional Order" category); Securities Exchange Act Release No. 61198 (Dec. 17, 2009) (granting approval of CBOE's proposal to adopt a professional customer designation).

[15] *See* "*Optimizing Our Equity Market Structure Opening Remarks*" at the Inaugural Meeting of the Equity Market Structure Advisory Committee, Chair Mary Jo White, U.S. Securities and Exchange Commission (May 13, 2015) ("I think much of the concern expressed about our current market structure can be distilled to at least a perception that it is *unnecessarily* complex. And by unnecessarily, I mean complexity that is not directed primarily toward producing better markets for investors and public companies. That kind of complexity can lead to less than an optimal equity market structure. [. . .] All of these potential effects can undermine investor confidence in the integrity and fairness of the equity markets.")

[16] Proposal at 87630.

[17] We note that the Proposal requires that at least 99% of a member's ELO Orders remain unaltered on the Nasdaq order book for a minimum of one second.

Nasdaq's statistical approach to enforcing the one-second minimum lifetime of ELO Orders creates inherent, even if unintended, conflicts between the different customers of a member.

Retail investors currently benefit from lower transaction costs due to market liquidity, greater competition, and narrower bid-ask spreads.[18] And retail investors are not having difficulty obtaining fills for non-marketable limit orders. The Proposal glosses over these facts in asserting that the introduction of additional complexity will benefit retail investors. In reality, the Proposal does not protect investors or the public interest, as required by Section 6(b)(5) of the Exchange Act.

IV. Expanding the Use of the ELO Attribute Will Only Amplify the Negative Impacts

Nasdaq expects to "extend the program to all Orders that meet the requirements of the [ELO Attribute] after its successful implementation with Designated Retail Orders."[19] Making the ELO Attribute available to all market participants will amplify the negative impacts on market liquidity, competition, and fairness described above, as it will increase the number of ELO Orders and the probability that a non-ELO Order will be jumped in priority at any given time.

In addition, if the ELO Attribute is made available to all market participants on the same terms as in the Proposal, we are concerned that it will lead to an explosion of new trading strategies that take advantage of the nuances of the rule. Under the Proposal, only 99% of a member's ELO Orders must actually remain unaltered on the Nasdaq order book for a minimum of one second.[20] This means that up to 1% of a particular member's ELO Orders can be cancelled or modified at will, yet still take advantage of the priority status accorded to ELO Orders. A firm could submit a significant number of orders away from the BBO to increase the total number of its orders that remain unaltered for at least one second and therefore count towards the 99% requirement. In doing so, the firm could ensure that it would have the flexibility to cancel other ELO Orders within one second when commercially advantageous, since those ELO Orders canceled within one second would still only account for less than 1% of its overall ELO Orders.[21]

V. Conclusion

The Proposal is a solution in search of a problem that does not exist. As structured, the Proposal would create complexities and potential conflicts that would inhibit competition between market participants – and in particular, between Nasdaq and broker-dealers. Approval of the Proposal would lead us down a down a slippery slope of increasingly complex order attributes – if approved, other exchanges are likely to introduce their own variations with different order durations receiving different priorities across our markets. In the end, the adulteration of price/time

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[18] *See, e.g.*, "Exclusive: Who Makes Money on Your Stock Trades," Barron's (Feb. 28, 2015), available at: http://www.barrons.com/articles/exclusive-who-makes-money-on-your-stock-trades-1425103695.

[19] Proposal at 87630.

[20] *Id.*

[21] Other complex issues are likely to arise and will need to be addressed if the Proposal is approved. For example, in light of the requirement that an ELO Order remain unaltered for a minimum of one second, a customer that wanted to cancel a resting order within one second, might, instead of canceling the order, simply trade against it.

priority is likely to negatively impact market liquidity and increase the costs of execution for retail and institutional investors alike. Sadly, this unnecessary complexity inevitably undermines investor confidence in the fairness of our markets. Therefore, Citadel strongly urges the Commission to disapprove the Proposal.

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

Respectfully,

/s/ Adam C. Cooper

Senior Managing Director and Chief Legal Officer