CITADEL | Securities

August 30, 2017

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

Re: Proposed Nasdaq Midpoint Extended Life Order (File No. SR-NASDAQ-2017-074)

Dear Mr. Fields:

Citadel Securities ("Citadel")[1] appreciates the opportunity to comment on Nasdaq Stock Market LLC's ("Nasdaq") proposal to create a new "Midpoint Extended Life Order" (a "MELO Order").[2]

Under the Proposal, MELO Orders will be priced at the midpoint between the NBBO and will not be eligible to execute until a "holding period" of a half-second has passed following acceptance of the order. In addition, a MELO Order will only be able to interact with other MELO Orders that have also met the holding period requirement.

As proposed, the MELO order type effectively operates a second, independent order book within the main Nasdaq matching engine. By design, MELO Orders will not interact with "standard" resting orders, and "standard" order flow will not interact with resting MELO Orders. As a result, the MELO order type creates an unprecedented level of exchange-based order flow segmentation that deserves careful analysis.

As the Securities and Exchange Commission (the "Commission") considers whether to approve or disapprove this Proposal, we detail below several issues that merit consideration and provide suggested refinements to the MELO order type.

I. Impact on Investors

Nasdaq asserts that this Proposal will allow "***all*** market participants to more effectively execute longer term investment strategies" through a "simple mechanism [. . .] with little impact to the operation of the markets."[3] However, at a minimum, this is not the case for (a) marketable held orders, and (b) resting orders that seek to interact with marketable held order flow. This is because held orders are typically required to be executed fully and promptly (see, for example, FINRA

---

[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. 34-81311 (Aug. 3, 2017), available at: https://www.sec.gov/rules/sro/nasdaq/2017/34-81311.pdf (the "Proposal").

[3] Proposal at pages 3 and 9.

Rule 5310.01). In addition, FINRA Best Execution Guidance 15-46, and references therein, require broker-dealers to consider price-improvement opportunities when handling customer orders. Given these requirements, broker-dealers typically utilize smart-order routers and other systems to seek out midpoint and other intra-spread liquidity that is dispersed across many market centers. Since held orders are often processed and executed in much less than a second, it may be inconsistent with regulatory requirements, as well as industry best practices, to delay this processing and execution for a full half-second as Nasdaq requires just to seek to interact with *potential* resting MELO Orders.

This effective exclusion from the MELO order type would be particularly impactful for retail orders, which are typically small in size and immediately executed. While the materiality of this exclusion will depend on the success of the MELO order type, it could be significant. As discussed above, the Proposal in effect creates a separate, parallel order book on the exchange, where only MELO Orders interact with each other. As use of this MELO order book increases, liquidity in the legacy Nasdaq order book could be negatively impacted to the detriment of retail investors. As a result, we urge the Commission to carefully scrutinize the potential impact of the Proposal on retail investors prior to granting approval.

The exclusion from the MELO order type for held orders may also negatively impact investors submitting resting MELO Orders, as they will no longer be able to interact with marketable held order flow. This is a strange outcome for a proposal that is intended to help market participants execute longer term investment strategies.

II. Modifications to Partially Mitigate Impact on Investors

Should the Commission determine that the degree of segmentation the Proposal would introduce is permissible within a single exchange, we recommend considering modifications to the Proposal that could partially mitigate the negative impacts of such segmentation, including on retail investors.

For example, Nasdaq could amend the Proposal to allow any order to immediately interact with a resting MELO Order as long as it is priced beyond the midpoint. This is based on the presumption that the type of order flow Nasdaq is trying to prevent from interacting with resting MELO Orders would typically be priced at the midpoint. This change would at least ensure that any order willing to cross the spread and take liquidity on the Nasdaq order book would benefit from, and provide benefit to, any existing mid-point MELO liquidity. However, this change would only partially mitigate the impact of the exclusion of retail orders from interacting with MELO Orders, because smart-order routers executing a client order may first seek out midpoint liquidity across multiple venues before taking liquidity at the full spread. Doing so requires that any order sent to a particular market center be priced at the midpoint, otherwise such an order would cross the spread and prematurely take liquidity before price improvement opportunities at other market centers could be explored.

III. Impact on Market Fairness and Complexity

Under the Proposal, executions resulting from MELO Orders "will be reported to the Securities Information Processor and will be provided in Nasdaq's proprietary data feed in the same manner as all other transactions occurring on Nasdaq".[4] This approach will likely raise concerns about market fairness and introduce significant complexity for investors, broker-dealers, and regulators when attempting to analyze market activity and assess execution quality.

For example, investors may see their own orders executed on Nasdaq at prices worse than other contemporaneous executions on the same exchange. Without Nasdaq labeling executions that result from MELO Orders, investors would have no way of knowing that their orders could not have been executed at such better prices because those executions were the result of MELO Orders that they could not access.

Similarly, MELO liquidity must be treated differently than other Nasdaq liquidity for purposes of routing logic and execution quality assessments. However, this will be extremely difficult to do successfully if executions resulting from MELO Orders are not labeled in a different manner than other executions on Nasdaq. As a result, broker-dealer routing logic may be influenced by liquidity that is not actually accessible, and regulators may experience difficulties in accurately filtering market data when evaluating compliance with regulatory requirements such as best execution.

Therefore, we urge the Commission to require that executions resulting from MELO Orders be marked as such on the tape. In the alternative, and taking into account that the MELO order type in effect creates a separate, parallel order book on the exchange, Nasdaq could offer the MELO order type on a separate exchange in order to avoid confusing MELO Order executions with other Nasdaq executions.

Separately, while we acknowledge the existence of limited exchange-based mechanisms that have the effect of restricting some order flow interaction, the Proposal goes significantly beyond any such existing restrictions. Absent modification, the use of Nasdaq's proposed MELO order type will result in two orders failing to interact even if they are of the same size and have prices that cross each other. For example, a retail investor order for 500 shares to buy a stock at $10.02 sent to Nasdaq would not interact with a resting MELO Order on Nasdaq to sell 500 shares of that same stock at $10.01. The Commission should consider carefully whether this failure to match otherwise completely "matchable" orders is consistent with the definition and purpose of an exchange.

IV. Additional Refinements to the Proposal

Apart from the issues detailed above, we urge Nasdaq to consider additional refinements to the Proposal to ensure that the MELO order type is employed as intended. For example, Nasdaq should clarify that MELO Orders may not be designated as immediate-or-cancel (IOC), as IOCs appear to be inconsistent with the MELO Order's holding period requirement.

---

[4] Proposal at page 13.

In addition, Nasdaq should reconsider whether it is advisable to allow MELO Orders to be canceled at any time, as proposed. Since the MELO Order is not priced until the end of the half-second holding period, there is no risk of it being priced at a purportedly "stale" midpoint. Allowing MELO Orders to be canceled at any time during the holding period does not appear to be consistent with the intended use of the order type. Instead, a MELO Order should only be permitted to be canceled after the holding period has expired and the order has been placed in the order book. Until then, any cancelation message would be held unactioned.

* * * * * * * * * *

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/ Stephen John Berger

Managing Director, Government & Regulatory Policy