CITADEL | Securities

January 17, 2017

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

Re: Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Adopt the CHX Liquidity Taking Access Delay (Release No. 34-79608; File No. SR-CHX-2016-16)

Dear Mr. Fields:

Citadel Securities ("Citadel")[1] appreciates the opportunity to comment further on the proposal by the Chicago Stock Exchange, Inc. ("CHX") to create an asymmetric access delay ("Access Delay") that would apply only to liquidity taking orders sent to CHX (the "CHX Proposal").[2] Citadel welcomes the Securities and Exchange Commission's (the "Commission") decision to institute proceedings to determine whether the proposed rule change should be approved or disapproved in light of the "legal and policy issues raised by the proposed rule change."[3]

As stated in our earlier comment letter,[4] CHX's proposed Access Delay would give liquidity providers a "last look" enabling them to back away from their quotations. We further detailed in our letter why the CHX Proposal is not consistent with Sections 6(b)(5) and 6(b)(8) of the Exchange Act and Rule 602 of Regulation NMS, and why, even if the CHX Proposal is approved, CHX quotations subject to the Access Delay should not be afforded protected quotation status under Regulation NMS. In the following pages, we outline further deficiencies of the CHX Proposal as well as address CHX's rebuttals.[5]

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[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 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. 78860, 81 FR 65442 (September 22, 2016) (SR-CHX-2016-16). The Access Delay would subject any order that would immediately execute against one or more resting orders on the CHX order book to an intentional delay of at least 350 microseconds before being processed. An order subject to such delay would only be released for possible execution after the CHX matching system processes all other messages received during the delay, except for other "delayable messages" (which also includes cancel and cancel/replace messages for orders that are subject to the Access Delay).

[3] Securities Exchange Act Release No. 79608, 81 FR 95238 (December 27, 2016) ("Order Instituting Proceedings").

[4] Letter from Adam C. Cooper, Senior Managing Director and Chief Legal Officer, Citadel Securities (October 13, 2016) ("Citadel Comment Letter I").

[5] Letter to Brent J. Fields, Secretary, Commission, from James Ongena, Executive Vice President and General Counsel, CHX (October 28, 2016) ("CHX Letter").

I. CHX's Proposed "Last Look" Functionality Disrupts Competition

If approved, the CHX Proposal would disrupt the competitive balance between liquidity providers and liquidity takers by giving liquidity providers a "last look" capability. In response, CHX asserts that "last look mechanisms necessarily require that the liquidity provider" has "knowledge of the marketable contra-side order" and "the ability to explicitly reject pending trades."[6] However, under CHX's Access Delay, a liquidity provider need not know the specific terms of an incoming order to have the benefit of a "last look," particularly when its quote is at the national best bid or offer ("NBBO"). A liquidity provider need only assess current market data to determine whether to remain firm for its quote *while* an incoming order is being delayed.

The introduction of this type of "last look" mechanism would distort the competitive playing field in our equity markets. The Order Protection Rule generally requires that orders be routed to the exchange displaying the best price.[7] With CHX's Access Delay, however, liquidity takers would find CHX's displayed liquidity fleeting since CHX liquidity providers could use this "last look" functionality to inform their decision to cancel their quotes. This is contrary to the principles of a free and open market, as required by Section 6(b)(5) of the Exchange Act.[8]

II. The CHX Proposal Unfairly Discriminates Between Liquidity Providers and Liquidity Takers, and Disproportionately Impacts Retail Investors

The CHX Proposal would provide an embedded advantage to certain market participants (*i.e.*, those who post quotes) over other market participants (*i.e.*, those who seek to access quotes).[9] This is motivated by CHX's flawed belief that the current national market system is "structurally biased" because "when reacting to the same symmetric information, a liquidity provider with a quote displayed on an exchange <u>must be faster</u> than a latency arbitrageur to avoid its stale quote from being executed."[10] CHX points to this alleged structural bias as its justification for why the discriminatory impact of the Access Delay against liquidity taking orders is not *unfairly* discriminatory.

CHX's premise that liquidity providers are entitled to structural advantages over liquidity takers, however, ignores the fundamental risks and rewards inherent in market making. A market maker that displays a quote is advertising this quote to the market, inviting liquidity takers to execute against it. This involves both risks and rewards. This risk is that the market moves against

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[6] CHX Letter at 13.

[7] 17 CFR 242.611.

[8] 15 U.S.C. 78f(b)(5).

[9] In fact, the primary evidence cited by CHX in support of the Access Delay is the extent to which certain CHX market participants try, but fail, to cancel their displayed firm quotes (presumably as a result of a market move), before those quotes could be accessed by other market participants (similarly responding to such a market move).

[10] CHX Letter at 4.

that quotation and the market maker receives an unfavorable execution.[11] The potential reward is that a market maker earns the spread between its bid and offer quotations.[12] The CHX Proposal seeks to eliminate the risk side of this equation for a select group of market participants, while preserving the rewards. The proposed Access Delay would virtually eliminate the risk of a liquidity provider receiving an unfavorable execution.[13]

Granting liquidity providers the advantage of avoiding all unfavorable executions is *unfairly* discriminatory against liquidity takers, and in particular against retail investors whose orders are primarily sent as market or marketable limit orders. The CHX Proposal repeatedly emphasizes that the Access Delay is narrowly tailored and would not materially affect liquidity taking orders from retail investors, notwithstanding the fact that the Access Delay would apply to all liquidity taking orders. However, Citadel's own data shows that typical retail order sending firms route more than 80% of retail investor orders as marketable orders. The Access Delay would thus deny executions for a far greater percentage of retail orders than CHX estimates.

III. The CHX Proposal Would Systematically Delay Access to Market Data, Violating Fundamental Principles of Our Markets

The express purpose of the Access Delay is to provide liquidity providers with the ability to intake and process current market data before other market participants. Slowing down liquidity taking orders by 350 microseconds to allow liquidity providers to process and react to current market data, and to cancel or modify their quotes in response thereto, is effectively the same as delaying the dissemination of market data to liquidity takers by 350 microseconds.[14] Allowing a select group of market participants to systematically receive access to market data faster than other market participants would violate the fundamental principles of just and equitable trade that are the foundation of the national market system. In fact, the selective dissemination of market data was the basis of an enforcement action against the New York Stock Exchange.[15] The proposed Access Delay should similarly be viewed as contrary to principles of just and equitable trade.

[11] For example, a market maker may post bid at $10.00, receive an execution, and a few moments later the bid price for that security drops to $9.95. In hindsight, the market maker may have wished that it had waited some amount of time to post its bid for the security at a lower price.

[12] Market-makers may enjoy other benefits, such as sharing in market data revenue or earning a rebate for posting liquidity.

[13] Further, this risk is eliminated without any commensurate assumption of additional obligations or responsibilities. By contrast, the Commission has previously expected such a balancing of benefits and obligations where an exchange attempts to grant special benefits to a select group of market participants. *See* Exchange Act Release No. 67437, 77 FR 42525, 42527 (SR-NYSEAmex-2011-86) (disapproving a proposed rule change that would allow certain market makers to access certain order information unavailable to other market participants).

[14] Because market data is available from numerous sources such as vendors and other exchanges, it would obviously not be possible to ensure that only liquidity providers on CHX received market data faster than liquidity takers. The point, however, is that the outcome is the same.

[15] *In the Matter of New York Stock Exchange LLC and NYSE Euronext*, Securities Exchange Act Release No. 67587 (Sept. 14, 2012).

IV. The Precedents CHX Cites to Justify the Access Delay's Discriminatory Impact Are Not Germane

CHX cites two precedents – maker/taker fees and bulk-quoting interfaces – in an attempt to justify the discriminatory impact of the Access Delay.[16] Neither of these precedents is germane to the analysis of the Access Delay:

- Maker/Taker Fees: The maker-taker fee structure creates a financial incentive for liquidity provision, while the Access Delay would embed a structural speed advantage in access to the exchange to a select group of market participants. Offering financial incentives through rebates is categorically different than an unavoidable, structural speed advantage. In the former case, market participants trading for their own account can and do adjust their quoting and liquidity-taking logic to reflect different maker-taker fees and structures. In the latter case, the advantage CHX wants to grant to certain market participants cannot be mitigated.

- Bulk-Quoting Interfaces: Bulk-quoting interfaces provided by certain options exchanges are justifiable given the substantial obligations undertaken by options market makers. For a single given underlying stock, options market makers provide quotations for hundreds of different options series. As the price of an underlying stock changes throughout the day, such changes affect the price of most or all of the options series for that stock. This creates a very practical need for an options market maker to update all its quotations in a single message. There is no comparable justification for favored treatment of CHX liquidity providers.

V. The CHX Proposal Would Undermine the Quote Rule

The CHX Proposal would have a significant and deteriorative impact on the Quote Rule.[17] CHX argues that the CHX Proposal comports with the Quote Rule because an order would not be "presented" to a liquidity provider until it was released from the Access Delay.[18] CHX's argument elevates form over substance and misses the point. Under the CHX Proposal, an order would obviously not be presented to a liquidity provider until it is released from the Access Delay. Nonetheless, the Access Delay would allow liquidity providers to selectively honor their quotations, an outcome that would gut the core of the Quote Rule.

VI. CHX Waives its Order Cancellation Fees for Certain Liquidity Providers

As stated in our prior comment letter, the proposed Access Delay would allow a liquidity provider to post quotations that it has little or no intention of executing. CHX argues in response that this would not occur because CHX imposes an "Order Cancellation Fee" on quotes that are

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[16] CHX Letter at 8.

[17] 17 CFR 242.602.

[18] CHX Letter at 11.

cancelled within 10 milliseconds. However, CHX neglected to state that this fee is waived for highly active liquidity providers.[19]

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The Commission should disapprove the CHX Proposal because, among others, it unduly burdens competition and is unfairly discriminatory, in contravention of the Exchange Act.

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

Respectfully,

/s/ Adam C. Cooper

Senior Managing Director and Chief Legal Officer

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[19] *See* CHX Fee Schedule at E.8(c): "Order Cancellation Fee Exemption. All Order Cancellation Fees assessed to an Account Symbol in a given month shall be waived if the Average Daily Volume attributable to the Account Symbol for the month is equal to or greater than 100,000 shares from single-sided orders executed at or greater than $1.00/share ("eligible executions")." "Account Symbol" refers to the unique identifier that CHX assigns to each trading account of a member."