CITADEL | Securities

March 14, 2017

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

Re: Proposed CHX Liquidity Enhancing Access Delay (Release No. 34-80041; File No. SR-CHX-2017-04)

Dear Mr. Aleman:

Citadel Securities ("Citadel")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") on the latest proposal by the Chicago Stock Exchange, Inc. ("CHX") to selectively delay access to CHX (the "Access Delay").[2] CHX attempted to implement a strikingly similar proposal – the "Liquidity Taking Access Delay" – in September 2016 (the "Withdrawn Proposal"), but withdrew the proposal following significant industry objections[3] and after the Commission instituted proceedings to determine whether to approve or disapprove the proposal.[4]

The new CHX Proposal – the "Liquidity Enhancing Access Delay" – is intended to achieve the same result as the Withdrawn Proposal, which is to provide a select group of liquidity providers with a significant structural advantage. However, the new CHX Proposal does not remedy any of the flaws previously identified with the Withdrawn Proposal. We thus once again urge the Commission to disapprove the CHX Proposal because it is not consistent with the requirements of the Exchange Act and the rules and regulations thereunder.[5] As was the case with the Withdrawn

[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] Exchange Act Release No. 80041, 82 FR 11252 (February 21, 2017) (SR-CHX-2017-04) (the "CHX Proposal").

[3] Commenters at the time argued that the Withdrawn Proposal was inconsistent with, among others, Sections 6(b)(5) and 6(b)(8) of the Securities Exchange Act of 1934 ("Exchange Act"), as well as the Commission's Interpretation Regarding Automated Quotations Under Regulation NMS (the "Automated Quotations Interpretive Guidance"). *See* comment file: https://www.sec.gov/comments/sr-chx-2016-16/chx201616.shtml.

[4] *See* Exchange Act Release No. 79680, 81 FR 95238 (December 27, 2016) (Order Instituting Proceedings to Determine Whether To Approve or Disapprove a Proposed Rule Change To Adopt the CHX Liquidity Taking Access Delay); and Exchange Act Release No. 79984, 82 FR 10521 (February 13, 2017) (Notice of Withdrawal of the LTAD Proposal).

[5] *See, e.g.,* Letters from Adam C. Cooper, Senior Managing Director and Chief Legal Officer, Citadel Securities, dated October 13, 2016 ("Citadel Letter 1") and dated January 17, 2017 ("Citadel Letter 2"). Citadel incorporates these letters by reference here.

Proposal, this Access Delay unfairly discriminates against certain market participants, unduly burdens competition, allows liquidity providers to back away from displayed quotations, and is not in the public interest. In addition, the CHX Proposal is inconsistent with the Commission's Automated Quotations Interpretive Guidance and the requirements for protected quotation status under Regulation NMS.

The new Access Delay will theoretically apply to all CHX orders. However, certain orders submitted by a new class of "LEAD Market Makers" ("LEAD MMs") are exempted from the Access Delay, including their (a) new incoming orders and modifications to resting orders (as long as they can be immediately ranked on the CHX book without executing against resting orders), and (b) cancellations of resting orders.[6] As a result, the new proposal closely resembles the Withdrawn Proposal, with a select group of liquidity providers (in this case, the LEAD MMs) benefitting from a structural advantage compared to other market participants. As before, this structural advantage is designed specifically to enable LEAD MMs to back away from their quotations, meaning that these quotations will no longer be reliably accessible and will not be comparable to quotations provided by liquidity providers on other exchanges.

I. The "LEAD Market Maker" Concept Is a Thinly Veiled Attempt to Replicate the Withdrawn Proposal

CHX does not dispute that the Access Delay is intended to create the same structural advantage for a select group of CHX liquidity providers as did the Withdrawn Proposal. In fact, CHX admits that the Access Delay will provide LEAD MMs with a "small head start" compared to other market participants.[7]

However, CHX attempts to justify this structural advantage in the latest proposal by pointing to the purportedly heightened quoting and trading obligations for LEAD MMs (the "LEAD Obligations").[8] In doing so, it appears that CHX is attempting to rely on prior Commission dicta providing that "while exchanges may legitimately confer special benefits on market participants willing to accept substantial responsibilities to contribute to market quality, such benefits must not be disproportionate to the services provided."[9] Unfortunately, the LEAD Obligations proposed by CHX appear to be largely immaterial in substance and the envisaged benefit is entirely disproportionate to these obligations.

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[6] *See* CHX Proposal at 11254. In addition, the portion of a routable order that that is to be routed away would not be subject to the Access Delay.

[7] *See* CHX Proposal at 11253.

[8] Specifically, the proposed LEAD Obligations require a LEAD MM to: (1) maintain a monthly average of quotations at the national best bid or offer ("NBBO") of at least 10%; (2) ensure that the LEAD MM's executions in the assigned security comprise an equally-weighted daily average of at least 2% of all executions in that security on CHX over the course of a month; and (3) ensure that at least 80% of these executions are against a quotation originating from the LEAD MM's Trading Account. CHX would also reduce by 50% the percentage away from the NBBO that a LEAD MM can quote. *See* Proposed CHX Article 16, Rule 4(f).

[9] Exchange Act Release No. 67437, 77 FR 42525, 42527 (July 19, 2012) (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).

CHX has provided no data regarding the materiality of the LEAD Obligations, how they will improve market quality, and whether CHX market makers already satisfy these criteria. For example, reducing the designated percentage away from the NBBO that a LEAD MM can quote is not significant if the reduced percentage is still much larger than the average quoted spread for the instrument. This should be expected given that the designated percentages were put in place for an entirely different purpose - avoiding executions against "stub quotes" following the 2010 Flash Crash, rather than to enhance market quality through establishing more rigorous quoting obligations.[10] Similarly, the proposed requirements for a LEAD MM to maintain quotations at the NBBO for at least 10% of a calendar month and to take part in at least 2% of qualified executions appear to be low thresholds for active liquidity providers. We urge the Commission to require CHX to provide data showing how its market makers perform against these thresholds today and how the proposed LEAD Obligations would materially improve market quality.

It is important to note that, even where market participants undertake significant obligations that contribute to market quality, the Commission has required that any corresponding benefit not be disproportionate to these obligations.[11] In this case, the proposed benefits to be accorded to LEAD MMs greatly outweigh the LEAD Obligations. Similar to the Withdrawn Proposal, LEAD MMs will be provided with a small amount of additional time to cancel or modify a resting quotation in response to current market information before an incoming order can execute against that quotation. This structural advantage is similar to a "last look" and fundamentally alters the risk/reward dynamics for CHX liquidity providers, as they can now avoid unfavorable executions by processing market data before other market participants.

By looking at data such as executions on other venues, a LEAD MM can infer when a marketable order is likely to execute against its quote and has a 350 microsecond speed advantage to determine whether it wishes to remain firm or cancel/modify its quote. A LEAD MM does not need to know the specific terms of an incoming order in order to perform this analysis, particularly when its quote is at the NBBO; a LEAD MM need only assess current market data to determine whether to remain firm for its quote *while* an incoming order is being delayed. This analysis will only be assisted by the fact that the CHX Access Delay will not apply to the portions of routable orders that are to be routed away, meaning that, depending on the location of the relevant matching engines, LEAD MMs may be able to observe these away executions and respond accordingly before the rest of the order clears the Access Delay.

The specific structural benefit that will be provided to LEAD MMs also serves to undermine the utility of the LEAD Obligations. For example, requiring LEAD MMs to provide quotations at the NBBO with more frequency will not improve market quality if these displayed quotations are, in practice, inaccessible to other market participants due to the ability of a LEAD MM to cancel or modify its displayed quotations.

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[10] *See e.g.*, Exchange Act Release No. 62950, 75 FR 59311 (Sept. 27, 2010) (SR-NASDAQ-2010-115) **(**noting that the enhanced market maker quotation requirements are "intended to eliminate trade executions against … 'stub quotes'").

[11] *Supra,* note 9.

II. The CHX Proposal is Inconsistent with the Exchange Act

The structural advantage that is proposed to be given to LEAD MMs raises the same concerns under the Exchange Act as did the access delay in the Withdrawn Proposal.

A. Unfair Discrimination and Undue Burden on Competition

The CHX Proposal results in unfair discrimination and an undue burden on competition in violation of Sections 6(b)(5) and 6(b)(8) of the Exchange Act. Notably, the Commission has stated that "[g]enerally, the Commission would be concerned about access delays that were imposed only on certain market participants."[12] This is precisely the case with the CHX Proposal, where LEAD MMs are able to bypass the Access Delay.

This asymmetric application of the Access Delay results in discrimination against other market participants, including both liquidity providers and liquidity takers, and fundamentally alters the competitive balance in the market. The CHX Proposal unfairly discriminates against non-LEAD MM liquidity providers by subjecting their orders to the Access Delay. This means that, in practice, liquidity providing orders from non-LEAD MMs will not post on the CHX book as quickly as liquidity providing orders from LEAD MMs.[13] In addition, non-LEAD MMs would not be able to cancel or modify their quotations as quickly as a LEAD MM, which could expose them to unfavorable executions that the LEAD MMs are able to avoid due to their structural advantage.[14] Notably, CHX proposes to exert an active role in administering this discriminatory treatment by determining who can qualify as a LEAD MM. Instead of relying solely on objective criteria, CHX also proposes to include subjective criteria, such as a firm's "willingness to promote [CHX] as a marketplace."[15] In essence, CHX will serve as a gatekeeper, determining which liquidity providers can benefit from a structural advantage compared to their competitors.

The CHX Proposal also unfairly discriminates against market participants that are primarily liquidity takers, such as retail investors. By imposing the Access Delay on all liquidity taking orders, but allowing LEAD MMs a head-start to cancel or modify displayed quotations, the CHX Proposal inhibits liquidity taker access to these displayed quotations. This fundamentally alters the competitive balance between liquidity providers and liquidity takers, as CHX LEAD MMs are effectively given extra time to determine whether to remain firm or cancel/modify a displayed quotation in order to avoid unfavorable executions.

[12] Automated Quotations Interpretive Guidance at FN 75.

[13] CHX does not appear to have acknowledged or provided a justification for this discriminatory treatment as required under the Exchange Act.

[14] For example, assume a LEAD MM and a non-LEAD MM each have a quote at the national best bid of $10.00, each for 100 shares. As a result of executions on other markets, both liquidity providers believe that the market may move against their quotation to a price of $9.99. The LEAD MM will be able to modify or cancel its quote immediately, while the non-LEAD MM's cancel message will be delayed for at least an additional 350 microseconds.

[15] Proposed CHX Article 16, Rule 4(f)(3)(A).

B. Inconsistency with the Firm Quote Rule

Rule 602 of Regulation NMS (the "Firm Quote Rule") is designed to "ensure that investors receive best execution and that the market receives reliable quotation information."[16] The rule requires a broker-dealer to execute any order to buy or sell a security that it receives at a price at least as favorable as its published bid or offer in any amount up to its published size, subject to certain exceptions.[17]

The CHX Proposal would undermine the Firm Quote Rule by allowing a LEAD MM to back away from its displayed quotation before a liquidity taking order could execute against that quotation.[18] Solely because of the Access Delay, a LEAD MM can effectively utilize a "last look" to cancel or modify the price of its displayed quotation before the earlier arriving liquidity taking order could execute. This structural advantage provided to LEAD MMs would fundamentally alter current market dynamics. Rather than all quotations being firm as required by the Firm Quote Rule, only quotations that a LEAD MM determined were in its interest to execute would actually be firm.

CHX argues that the CHX Proposal comports with the Firm Quote Rule because an order would not be "presented" to a LEAD MM until it was released from the Access Delay.[19] However, this argument elevates form over substance. The Firm Quote Rule was specifically designed to prevent market participants from selectively honoring quotations.[20] The Access Delay would allow just that by enabling a LEAD MM to back away from its displayed quotation before a liquidity taking order could execute against that quotation.

C. Not Designed to Protect Investors or the Public Interest

Section 6(b)(5) of the Exchange Act requires that the rules of an exchange protect investors and the public interest.[21] As discussed above, the CHX Proposal fails to protect market

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[16] Exchange Act Release No. 40260, 63 FR 40748, 40754 (July 30, 1998).

[17] 17 CFR 242.602.

[18] For example, assume three exchanges, one of which is CHX represented by a LEAD MM, are each displaying a bid for 100 shares at the NBB of $10.00, and a retail investor enters an order to sell 300 shares. The retail investor's broker-dealer routes one-third of the total order to each exchange. Part of the retail investor's order gets executed on the other two exchanges for a total of 200 shares, but 100 shares fails to execute on CHX since the portion routed to CHX is subject to the Access Delay and the CHX LEAD MM has canceled its displayed quote based on the most recent market data even though this part of the investor order has already arrived for execution at CHX. As a result, one-third of the retail investor's total order fails to execute at $10.00 and would likely be subsequently executed at a lower price, harming the retail investor.

[19] CHX Proposal at n.128.

[20] This behavior was prevalent in the 1990s, leading the Commission to take both enforcement and regulatory action to eliminate the practice of backing away from displayed quotations, stating that "[f]ailure to honor quotations deprives investors of the liquidity that market makers advertise they will provide and injures the credibility of the market as a whole." Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD, the Nasdaq Market, and Nasdaq Market Makers, Exchange Act Release No. 37542, at 32 (August 8, 1996).

[21] 15 U.S.C. 78f(b)(5).

participants that primarily act as liquidity takers, such as retail investors. By hindering their ability to access displayed quotations on CHX that originate from LEAD MMs, the CHX Proposal undermines overall investor confidence in market transparency and efficiency. The express purpose of the Access Delay is to provide LEAD MMs with the ability to intake and process current market data before other market participants. Slowing down liquidity taking orders by 350 microseconds to allow LEAD MMs 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. We assert that this outcome is not in the public interest.

As with the Withdrawn Proposal, the Access Delay is specifically designed to benefit a select group of highly sophisticated market participants. In addition to evaluating the impact of the proposed structural advantage vis-à-vis other market participants, the Commission should also assess whether the CHX Proposal could be expected to impact the distribution of market data revenue. For example, under the current CHX fee schedule, CHX market makers and liquidity providers can share in the exchange's market data revenue when displaying a competitive quotation, regardless of whether or not that quotation results in a trade.[22] Providing LEAD MMs with additional time to cancel or modify a resting quotation in response to current market information could incentivize the display of tighter quotations without ensuring that such quotations are able to be reliably accessed by other market participants.

III. The Access Delay Is Not *De Minimis* under the Commission's Interpretive Guidance

In addition to being inconsistent with the Exchange Act, the Access Delay is also inconsistent with the Commission's Automated Quotations Interpretive Guidance.[23] In this guidance, the Commission stated that Rule 611 does not preclude a *de minimis* intentional delay, which is a delay that is "so short as to not frustrate the purposes of Rule 611 by impairing fair and efficient access to an exchange's quotations."[24] However, the Access Delay is plainly not *de minimis* as it is specifically designed to "neutralize" and "minimize the effectiveness of" certain orders on CHX by impairing the fair and efficient access to LEAD MM quotations displayed on CHX.[25]

The Access Delay is significantly different from the intentional delay imposed by IEX that prompted the Automated Quotations Interpretive Guidance. First, allowing LEAD MMs to bypass the Access Delay results in asymmetrical application (as it only applies to certain market participants) and denies liquidity takers fair and efficient access to CHX quotations. Second, during the delay, CHX LEAD MMs are able, unfairly, to decide on a quotation-by-quotation basis whether to cancel or modify the quote, benefiting from a structural advantage in the process. Third,

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[22] *See* CHX Fee Schedule, available at http://www.chx.com/regulatory-operations/rules/ and CHX, "Market Data Revenue & SIPs," available at http://www.chx.com/chxshare/market-data-revenue.html. CHX allocates a portion of market data revenue to its members based on both "Quote Revenue" and "Trade Revenue."

[23] We incorporate by reference our more general concerns with the Automated Quotations Interpretive Guidance. *See* Letter to Brent J. Fields, Secretary, Commission, from John C. Nagel, Managing Director and Sr. Deputy General Counsel, Citadel LLC (April 14, 2016).

[24] Automated Quotations Interpretive Guidance at 40786.

[25] CHX Proposal at 11270.

the Access Delay may not be limited to 350 microseconds and could vary on an order-by-order basis depending on how quickly CHX processes other messages in the relevant security that were received during the delay period.[26] This additional delay may be material, particularly during times of market stress, and could significantly impact liquidity taking retail orders or those seeking to hedge positions, such as market participants providing liquidity in ETFs and seeking to hedge in the underlying securities.

Given that the CHX Proposal would operate as a symmetric access delay in some cases and as an asymmetric access delay when a LEAD MM is involved, the analysis of whether a particular CHX quotation is considered automated may need to take into account the specific market participants involved. At a minimum, CHX LEAD MM quotations that can be cancelled or modified without being subject to the Access Delay should not be afforded protected quotation status under Regulation NMS. Otherwise, liquidity takers will find CHX's displayed liquidity fleeting as they seek to comply with the Order Protection Rule, which generally requires that orders be routed to the exchange displaying the best price.[27]

IV. CHX Is Unable to Justify the Structural Advantage Provided to LEAD MMs

The CHX Proposal attempts to justify providing a select group of liquidity providers with an unprecedented structural advantage by suggesting that there is a fundamental flaw in current market structure, evidenced by its own declining market share in *one* security.[28] However, the premise that a market failure has occurred if a liquidity provider attempts to cancel a quotation, but is unable to do so prior to its execution is fundamentally flawed. In addition, the declining market share of a single exchange in a single security is insufficient to justify a change of this magnitude, which is much different than offering liquidity providers financial incentives through rebates, for example. The lack of data evidencing any market-wide problem highlights that the overriding purpose of the CHX Proposal is to provide CHX liquidity providers with an ingrained structural advantage in order to increase CHX's market share. Despite assertions that the Access Delay is narrowly tailored and would not materially affect liquidity taking orders from retail investors, Citadel's own data shows that typical retail order sending firms route more than 80% of retail investor orders as marketable orders. As a result, the Access Delay would risk impairing access to displayed quotations and denying executions for a far greater percentage of retail orders than CHX estimates.

V. Conclusion

Similar to the Withdrawn Proposal, this Access Delay would enable LEAD MMs to back away from their purportedly firm quotations. This structural advantage is inconsistent with both the Exchange Act and Regulation NMS and would undermine the healthy functioning of the national market system. Under the CHX Proposal, LEAD MMs would be subject to LEAD Obligations that appear to be largely immaterial in substance and, in turn, would benefit from an advantage that is entirely disproportionate to those obligations. This advantage unfairly discriminates against

[26] *See id.* at n.48.

[27] 17 CFR 242.611.

[28] *See* CHX Proposal at 11253.

liquidity takers and other liquidity providers, fundamentally altering the competitive balance that exists in the current market structure.

The CHX Proposal is ultimately designed to benefit a select group of CHX liquidity providers and the market share of CHX at the expense of overall market quality. For the foregoing reasons, Citadel strongly urges the Commission to disapprove the CHX Proposal.

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We appreciate the opportunity to provide comments on the CHX Proposal. Please feel free to call the undersigned at (646) 403-8235 with any questions regarding these comments.

Respectfully,

/s/ Stephen John Berger
Managing Director, Government & Regulatory Policy