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March 10, 2020

Ms. Vanessa Countryman  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C., 20549-1090

Re: Release No. 34-87814; File No. SR-IEX-2019-15

Dear Ms. Countryman:

DLA Piper (US) LLP submits this comment letter to the Securities and Exchange Commission ("Commission") on behalf of a client with respect to the above-referenced rule proposal filed by the Investors Exchange LLC ("IEX").<sup>1</sup> IEX proposes to add a D-Limit order, a displayed or non-displayed limit order that will be subject to automatic adjustment by IEX via an algorithm to a less-aggressive price during periods of quote instability, as defined in IEX rules. Currently, this type of adjustment is permitted only on IEX non-displayed order types.

For the reasons set forth below, we respectfully submit that the Commission should disapprove the IEX Proposal as inconsistent with the Securities Exchange Act of 1934, as amended (the "Act") because the proposed repricing of displayed orders is inconsistent with both the Quote Rule<sup>2</sup> and the Order Protection Rule,<sup>3</sup> impermissibly allows IEX to perform broker functions, and would result in market harm and unfair discrimination.

### **Current and Proposed IEX Order Types**

IEX currently offers non-displayed order types that are subject to automatic algorithmic adjustment to a less aggressive price during periods of quote instability. These non-displayed order types include the non-displayed Discretionary Peg ("DPeg"), an order pegged to the national best bid ("NBB") for buy orders or the national best offer ("NBO") for sell orders, with discretion to exercise up to the midpoint of the NBBO. Similarly, the non-displayed primary peg ("PPeg") order type is pegged to one tick below the NBB for a buy order and one tick above the NBO for a sell order, but is also available to trade at a price up to the NBB or down to the NBO, unless further restricted by the order's limit price. When these non-displayed orders are eligible to trade at prices more aggressive than their default prices, they are said to be exercising discretion.

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<sup>1</sup> Notice of Filing of Proposed Rule Change To Add a New Discretionary Limit Order Type, Exchange Act Release No. 87814, 84 FR 71997 (Dec. 30, 2019) ("IEX Proposal").

<sup>2</sup> 17 CFR 242.602.

<sup>3</sup> 17 CFR 242.611.



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IEX uses a proprietary mathematical calculation, the crumbling quote indicator (“CQI”), to determine when its non-displayed pegged order types are eligible to exercise discretion. IEX claims that the CQI “is designed to predict whether a particular quote is unstable or ‘crumbling,’ meaning that the NBB is likely about to decline or the NBO is likely about to increase.”<sup>4</sup> As described in the IEX Proposal, IEX utilizes real-time relative quoting activity of “certain Protected Quotations and a proprietary mathematical calculation (the ‘quote instability calculation’) to assess the probability of an imminent change to the current Protected NBB to a lower price or Protected NBO to a higher price for a particular security (‘quote instability factor’).”<sup>5</sup> If a quote is determined by IEX to be unstable, IEX will then prevent non-displayed DPeg and PPeg orders on that side of the market from exercising discretion and trading at a price that is more aggressive than their default resting prices.

According to IEX, the proposed D-limit order would “extend the protective features of the CQI to displayed and non-displayed D-Limit orders to protect such orders from potential adverse selection by preventing them from trading at a price that IEX’s CQI formula predicts is unstable and thus imminently stale.”<sup>6</sup> In other words, IEX would adjust the price of a displayed order that is IEX’s protected quote to a less aggressive price if IEX determines, via its CQI, that the quote is unstable.

### **The IEX Proposal Is Inconsistent with the Quote Rule**

The Quote Rule, which has been in place more than 40 years, is designed to assure the reliability and availability of quotation information throughout the U.S. securities markets.<sup>7</sup> Currently codified as NMS Rule 602, the Quote Rule requires a national securities exchange to establish procedures for collecting, processing, and making available to vendors the best bid, best offer, and aggregate quotation sizes for NMS securities that are communicated on that exchange by an exchange member to another member.

The Quote Rule also establishes broker-dealer requirements. When a broker-dealer that is a member of an exchange communicates bids or offers in NMS securities to other members of that exchange, that broker-dealer is obligated under the Quote Rule to communicate its best bids, best offers, and quotation sizes to the exchange and to be “firm” for those published quotes. Under the Quote Rule, a “firm” quotation generally means a broker-dealer has an obligation “to execute any order . . . at a price at least as favorable . . . as [its] published bid or published offer . . . in any amount up to its published quotation size.”<sup>8</sup> There are exceptions, including that “before the order sought to be executed is presented, . . . [the] broker or dealer

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<sup>4</sup> See IEX Proposal, *supra* note 1 at 71998.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 72000.

<sup>7</sup> The Quote Rule was previously codified in Rule 11Ac1-1 under the Act. See Securities Exchange Act Release Nos. 14415 (January 26, 1978), 43 FR 4332 (February 1, 1978) and 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996).

<sup>8</sup> 17 CFR 242.602(b)(2).



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has communicated to its exchange . . . a revised bid or offer.”<sup>9</sup>

The IEX Proposal is inconsistent with these principles and the intent behind them because it would effectively allow IEX liquidity providers to back away from their quotes. While incoming orders would be subject to the access delay, the quotes of liquidity providers would be updated to inferior prices without delay. This renders their quotes nothing more than a “maybe” quote or indication of interest. Accordingly, we believe that the Commission must disapprove IEX’s proposal as inconsistent with the Quote Rule.

### **The IEX Proposal Is Inconsistent with the Order Protection Rule**

The Order Protection Rule is a foundational element of our national market system. Rules limiting trading at inferior prices were adopted on certain markets more than 40 years ago.<sup>10</sup> In 2005, the Order Protection Rule was adopted for all exchanges as part of Regulation NMS.<sup>11</sup> As noted by the Commission in the adopting release, the rule “reinforces the fundamental principle of obtaining the best price for investors when such price is represented by automated quotations that are immediately accessible.”<sup>12</sup> Under Regulation NMS, a trading center displaying an automated quotation must provide “immediate-or-cancel” (“IOC”) functionality for an incoming order to execute immediately and automatically against the displayed quotation up to its full size, and for any unexecuted portion of such incoming order to be cancelled immediately and automatically without being routed elsewhere.<sup>13</sup> Thus, to qualify as an automated trading center, “the trading center must have implemented such systems, procedures, and rules as are necessary to render it capable of displaying quotations that meet the action, response, and updating requirements set forth in the definition of an automated quotation.”<sup>14</sup>

When IEX sought approval to become an exchange in 2016, concerns were raised about the IEX access delay of 350 milliseconds for all incoming orders.<sup>15</sup> In a 2016 interpretation issued in conjunction with the approval of IEX as an exchange, the Commission determined that in the context of the Order Protection Rule, the term “immediate” does not preclude a programmed

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<sup>9</sup> 17 CFR 242.602(b)(3)(ii). In addition, the Quote Rule does not require a broker-dealer to be “firm” for its published quotation if, “[a]t the time the order sought to be executed is presented, such . . . broker or dealer is in the process of effecting a transaction. . . .” *Id.*

<sup>10</sup> Regulation NMS: Proposed Rules and Amendments to Joint Industry Plans, Exchange Act Release No. 49325, File No. S7-10-04 (Feb. 26, 2004); 69 FR 11125, 11129 (March 9, 2004).

<sup>11</sup> Regulation NMS: Final Rules and Amendments to Joint Industry Plans, Exchange Act Release No. 51808, File No. S7-10-04 (June 9, 2005), 70 FR 37496 (June 29, 2005) (“Regulation NMS Adopting Release”).

<sup>12</sup> *Id.* at 37497.

<sup>13</sup> *See* 17 CFR 242.600(b)(3) (defining the term “automated quotation”) and 17 CFR 242.600(b)(57) (defining the terms “protected bid or protected offer,” together, a “protected quotation,” to mean an automated quotation that is the best bid or best offer of a national securities exchange).

<sup>14</sup> *See* Regulation NMS Adopting Release, *supra* note 11, at 37520.

<sup>15</sup> In the Matter of the Application of Investors’ Exchange, LLC for Registration as a National Securities Exchange, Exchange Act Release No. 78101, File No. 10-222 (June 17, 2016), 81 FR 41142, 41156, note 216 (June 23, 2016) (“IEX Approval Order”).



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delay that is de minimis, provided that such delay “does not impair fair and efficient access to an exchange’s protected quotation.”<sup>16</sup>

In 2016, concerns were also expressed about IEX’s crumbling quote re-pricing functionality, and specifically, that extending the CQI functionality to displayed orders would be inconsistent with Rule 611’s order protection obligations. In response, the Commission noted that:

IEX will only reprice pegged orders, which are non-displayed. Non-displayed orders are not reflected in an exchange’s quotations, and Rule 611 applies order protection to publicly displayed quotes only. Accordingly, an access delay that does not allow the repricing of displayed orders does not impact an exchange’s displayed quotation, and cannot be said to lead to “maybe” quotations.<sup>17</sup>

The IEX Proposal now directly presents the issue that was raised in 2016, but was not specifically addressed because at the time, IEX proposed to apply CQI only to non-displayed orders. As noted above, an exchange function that adjusts the price of displayed quotations because an exchange believes that there is a probability that the NBBO might move would result in conditional or “maybe” quotations. Access to these “maybe” quotations would be further frustrated because IEX proposes to adjust the price of resting orders in real-time, yet apply the access delay to liquidity-taking orders seeking to trade with that displayed liquidity. In combination, IEX’s proposal to adjust the price of displayed quotes on IEX in real-time and then deliberately hinder access through its programmed delay is inconsistent with the requirements for immediate and automatic execution required for automated quotations to be protected under the Order Protection Rule and would frustrate the rule’s purposes.

IEX’s proposal is fundamentally different than the repricing functionality offered by other markets. Other markets reprice displayed orders after market forces move the NBBO, an objective event outside the control of individual market participants. Such repricing is designed to prevent either locked or crossed markets or violations of the Order Protection Rule. In contrast, IEX is proposing to re-price displayed orders based on IEX’s own subjective probability measurements before the NBBO actually moves.

For these reasons, we believe that the Commission must disapprove the IEX Proposal as inconsistent with both the text and the purposes of the Order Protection Rule.

### **The IEX Proposal Would Permit IEX to Exercise Broker Functions Inconsistent with its Exchange Status**

To date, exchanges have not been permitted to re-price displayed orders based on a subjective assessment that there is a probability that the market may move in an adverse manner. Of course, many exchanges offer order types pegged to the NBBO; after market forces move the

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<sup>16</sup> Commission Interpretation Regarding Automated Quotations under Regulation NMS, Exchange Act Release No. 78102, File No. S7-03-16 (June 17, 2016), 81 FR 40785, 40791 (June 23, 2016).

<sup>17</sup> IEX Approval Order, supra note 15.



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NBBO, the order will adjust automatically in response. In these cases, market forces prompt and precede the adjustment. Here we have the reverse: IEX would be able to change the price of displayed orders based on a subjective probability and assessment that the market may move adversely before it actually does. In this way, IEX would be exercising discretion over client orders, a function that has required registration as a broker-dealer. Broker-dealers or their customers exercise the discretion to change their orders in response to expected market forces by cancelling or modifying their orders; the IEX Proposal would place an exchange in the role of doing that instead.

The IEX Proposal represents a significant departure from the structure and separation of exchange and broker-dealer roles. Indeed, the Commission has previously disapproved proposed exchange functionalities that competed with services offered by broker-dealers.<sup>18</sup> Before approving the IEX Proposal or others like it, we urge the Commission to articulate clear boundaries around when an exchange (i) may or may not offer services historically performed by broker-dealers and (ii) may apply predictive analysis to price a displayed order.

#### **The IEX Proposal Would Result in Market Harm**

Approving the IEX proposal would set the precedent for other exchanges to offer similar functionality. If other markets were to follow suit and adopt similar rules, the result would be flickering quotes across all markets and a significant degradation in price discovery. As investors become aware that the U.S. equities displayed markets are not firm, this could result in a loss of public confidence in our markets.

IEX uses policy arguments to support its proposal, namely, that the proposed functionality would protect displayed orders from “adverse selection” and points to only one month’s worth of trading data to justify its conclusions about adverse selection. But any attempt to rely on policy arguments also needs to consider the harms that would result from this functionality. Market participants would not know which IEX displayed quotations would be subject to the CQI and thus be eligible to fade, effectively turning what are supposed to be immediately accessible firm quotes into non-firm indications of interest. The proposal would harm less-sophisticated market participants trying to access IEX’s protected quotes. Such investors (including retail investors submitting market orders) have no choice and would receive worse executions because IEX would move quotes to inferior prices.

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<sup>18</sup> See, e.g., Securities Exchange Act Release No. 68629 (January 11, 2013), 78 FR 3928, 3931 (January 17, 2013) (SR-NASDAQ-2013-059) (Order disapproving proposal to establish “benchmark orders” because, in part, the proposed functionality would create regulatory disparities that would give NASDAQ an inappropriate advantage over broker-dealers providing the same services and therefore the Commission could not find that the proposal would be consistent with Section 6(b)(8) of the Exchange Act).



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### **The IEX Proposal Would Unfairly Discriminate Against Liquidity Takers**

IEX has not provided specific analysis or demonstrated why the proposed rule change would not permit unfair discrimination against liquidity taking orders that are not related to latency arbitrage. IEX's own data analysis substantiates that even during periods when IEX's CQI is on, IEX receives liquidity-taking orders not only from proprietary trading firms but also from "full service broker-dealers" and "agency broker-dealers."<sup>19</sup> IEX simply states that it is "more likely" to receive orders from proprietary trading firms during these periods, but does not, and cannot, say that it does not receive orders during these periods from agency broker-dealers that, by IEX's own description, are not engaging in latency arbitrage. But such liquidity takers would not be aware of, or be able to easily replicate, IEX's formula for determining the probability of a price movement

The fact that IEX's CQI formula is public does not reduce discriminatory harm that the IEX Proposal could create. To protect against such results, other markets participants would have to build technology to mimic or predict the CQI functionality. That would be a prohibitively expensive option for many of them and completely impractical if other markets adopted similar rules. The proposal therefore also unfairly discriminates between fast and slow liquidity takers, and IEX fails to explain why it needs to implement a change that would impact liquidity takers that are not engaging in latency arbitrage.

Nor has IEX provided any analysis of why the benefits of fading quotes for liquidity providers are being provided without a corresponding obligation for such market participants, particularly since the proposed functionality would unfairly discriminate against liquidity takers.

For these reasons, we respectfully submit that IEX has not met its burden of demonstrating that its proposal is consistent with the Act, and accordingly the Commission should disapprove the IEX Proposal.

Very truly yours,

A handwritten signature in blue ink that reads 'Mary M. Dunbar'.

Mary M. Dunbar

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<sup>19</sup> See note 58 and accompanying text.