CITADEL | Securities

March 30, 2017

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

Re: Order Instituting Proceedings to Determine Whether to Approve or Disapprove the Proposed Nasdaq Extended Life Priority Order Attribute (Release No. 34-80149; File No. SR-NASDAQ-2016-161)

Dear Mr. Aleman:

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

As detailed in our earlier comment letter,[4] and in letters from other market participants,[5] the Nasdaq Proposal is not designed to protect investors or the public interest and creates an undue burden on competition. Unfortunately, Nasdaq's responses to these concerns,[6] and the relatively minor changes contained in Amendment No. 1,[7] do not address the fundamental deficiencies of the Nasdaq Proposal, as described further below.

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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. 79428, 81 FR 87628 (December 5, 2016) (the "Nasdaq Proposal").

[3] Securities Exchange Act Release No. 80149, 82 FR 13168 (March 9, 2017) ("Order Instituting Proceedings").

[4] Citadel incorporates by reference its previous comment letter on the Nasdaq Proposal. *See* Letter to Brent J. Fields, Secretary, Commission, from Adam C. Cooper, Senior Managing Director and Chief Legal Officer, Citadel Securities, dated December 27, 2016 ("Citadel Letter 1").

[5] *See* comment file: https://www.sec.gov/comments/sr-nasdaq-2016-161/nasdaq2016161.shtml.

[6] *See* Letter to Brent J. Fields, Secretary, Commission, from T. Sean Bennett, Principal Associate General Counsel, Nasdaq Inc. dated February 17, 2017 ("Nasdaq Letter").

[7] Amendment No. 1 modified the Nasdaq Proposal to provide, among others, that: (1) Nasdaq will review compliance with the eligibility criteria monthly rather than quarterly, and (2) Nasdaq will implement certain new, unspecified surveillances to detect any potential misuse of the ELO Attribute. *See* Amendment No. 1.

I. The Nasdaq Proposal Is Not Designed to Protect Investors or the Public Interest

A. Information Leakage

Numerous commenters have cited concerns regarding information leakage given that Nasdaq proposes to identify ELO Orders in its proprietary data feed.[8] In response, Nasdaq asserts that "[r]etail investor interest is most often represented with one order at a single price and, as such, information leakage is not a concern."[9] We respectfully disagree.

Two aspects of the Nasdaq Proposal serve to heighten these concerns regarding information leakage and distinguish the ELO Attribute from any existing retail order identifiers used by other exchanges.[10] First, ELO Orders are generally required to exist unaltered on the Nasdaq book for a minimum of one second.[11] This information would be provided to other market participants when ELO Orders are identified in Nasdaq's data feed, and may impact routing strategies in ways that would adversely affect execution quality for ELO Orders. For example, a market participant that is looking to take liquidity from multiple trading centers may route to an ELO Order last because it knows that such order will not be cancelled for at least one second. This could result in lower fill rates for ELO Orders since the market participant may fill its order on the venues it routes to first before routing to the ELO Order on Nasdaq.[12]

Second, it is not clear how an individual retail investor can effectively opt-out of using the ELO Attribute if such investor is concerned about information leakage. It appears that, in many cases, Nasdaq expects members will designate all orders being entered through a particular entry port as ELO Orders.[13] This means that, in practice, the relevant retail broker-dealer will be making the determination as to whether to use the ELO Attribute, instead of retail investors making that determination on an order-by-order basis.

B. Misuse By Professional Traders

Commenters also raised concerns regarding the potential for professional traders to utilize the ELO Attribute in order to obtain a competitive advantage over other market participants. In

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[8] *See* comment file: https://www.sec.gov/comments/sr-nasdaq-2016-161/nasdaq2016161.shtml.

[9] Nasdaq Letter at 6.

[10] For example, Nasdaq cites to BATS BZX Exchange Rule 11.25(e). Nasdaq Letter at 7.

[11] Nasdaq Proposal at 87629. We note that the Nasdaq 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.

[12] For example, assume a market participant sees 500 shares at the NBB of $10.00 across five venues with Nasdaq displaying an ELO Order for 100 shares as its only quotation at this price. A market participant looking to fill a marketable sell order for 500 shares may receive executions against non-displayed liquidity (in addition to the displayed liquidity) on the four venues that it routes to first, removing any need to route to Nasdaq. If the ELO Order was not identified as such, the market participant may have instead routed to Nasdaq first.

[13] Nasdaq Proposal at 87630-31.

response, Nasdaq points to the definition of a "Designated Retail Order", including the requirement that it originate from a natural person.[14] Unfortunately, this does not allay the concerns.

In particular, Nasdaq fails to explain how highly sophisticated day traders or other professional traders *that are natural persons* will be prevented from utilizing the ELO Attribute. Experience in the equity options market suggests that professional traders will seek to take advantage of customer priority rules specifically designed for retail investors.[15] Employing the ELO Attribute will allow these professional traders to gain priority over other resting orders, while still retaining the ability to opportunistically cancel orders within one second given that the retrospective review of cancellation rates performed by Nasdaq will take place at the member broker-dealer level rather than on an investor-by-investor basis.

II. The Nasdaq Proposal Creates an Undue Burden on Competition and Is Incompatible with FINRA Rule 5320

In our prior comment letter, we raised concerns regarding the interaction between FINRA Rule 5320[16] and the Nasdaq Proposal.[17] Specifically, the operation of FINRA Rule 5320 will, in certain circumstances, result in a broker-dealer filling a held customer order and cancelling the customer's resting order within one second. This could impact the ability of wholesale broker-dealers, in particular, to maintain compliance with the 99% threshold imposed by Nasdaq in order to be eligible to utilize the ELO Attribute.

In response, Nasdaq points to the "no-knowledge" exception contained in Supplementary Material .02 of FINRA Rule 5320, which generally allows a firm to engage in proprietary trading as long as it is separate from the trading unit handling customer orders.[18] However, Nasdaq has missed the point of our concern, which is when the "no-knowledge" exception is not used or available. Firms often choose not to use the "no-knowledge" exception while still providing Manning protection to customer orders in order to provide higher fill rates or price improvement to their customer orders. Under these circumstances, filling a client order in accordance with Rule 5320 may require the cancellation within one second of an order marked with the ELO Attribute.

For example, assume that shortly (within one second) after a firm has routed a customer's ELO Order to rest at the national best bid at Nasdaq, the firm is filled at that same price and size on another market or venue. FINRA Rule 5320 requires the firm to immediately execute the original

[14] Nasdaq Letter at 5-6.

[15] It was precisely for this reason that the options markets created the "professional" order type designation to scale back priority advantages for certain sophisticated traders. *See* Exchange Act Release No. 59287, 74 FR 5694 (January 30, 2009) (SR-ISE-2006-26).

[16] FINRA Rule 5320, also known as the "Manning" rule, provides in relevant part 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."

[17] *See* Citadel Letter 1.

[18] Nasdaq Letter at 5.

customer's order, after which it would need to cancel the resting ELO Order to avoid double-filling the customer. In other contexts, such as facilitating a customer-cross, the "no-knowledge" exception would not apply and a firm may also have to cancel an ELO Order within one second in order to comply with FINRA Rule 5320.[19]

Nasdaq has failed to adequately take into account FINRA Rule 5320 when developing its proposal, particularly with respect to the requirement that at least 99% of a member's ELO Orders remain uncancelled on the Nasdaq order book for a minimum of one second. In complying with FINRA Rule 5320, a broker-dealer may fall below the 99% threshold, thereby losing eligibility to utilize the ELO Attribute. This would be a perverse outcome that creates an undue burden on competition for firms that handle a significant amount of retail orders.

III. The Nasdaq Proposal Will Negatively Impact Market Liquidity, Competition, and Fairness

Commenters also raised concerns regarding market liquidity, competition, and fairness resulting from the introduction of the ELO Attribute. For example, the Nasdaq Proposal fundamentally changes the well-established principle of price/time priority, and therefore will require liquidity providers to take into account the possibility that their orders will be jumped in priority at any given moment. This will increase the complexity and risks associated with providing liquidity, potentially resulting in wider spreads that will adversely impact both retail and institutional investors.

In response, Nasdaq states that "[i]t is Nasdaq's belief that ELO is a useful and beneficial order attribute, but if ultimately Nasdaq is incorrect and market quality does not improve, market participants may choose one or more of the many substitutes in the market where participants may send their orders."[20] We urge the Commission to require more from Nasdaq before allowing the introduction of an order attribute that will significantly increase complexity in the market.

Specifically, Nasdaq has failed to provide any data evidencing that retail investors are experiencing difficulties in obtaining fills for non-marketable limit orders under the current market structure. In contrast, 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%.

Similarly, Nasdaq has failed to provide data to support the speculative benefits that are asserted in the proposal. Nasdaq even 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.[21] The burden should be on Nasdaq to clearly justify why it is in the public interest to move away from this market structure,

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[19] For example, if a firm posts an ELO Order and within one second it receives another customer order marketable against the ELO Order, the firm would have to cancel the ELO Order immediately to facilitate a riskless principal transaction in accordance with FINRA Rule 5320.03.

[20] Nasdaq Letter at 3.

[21] Nasdaq Proposal at 87629.

thereby increasing complexity for all market participants. Nasdaq has thus far failed to satisfy this burden.

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For the foregoing reasons, Citadel believes that the Proposal should be disapproved. Please feel free to call the undersigned at ([redacted] with any questions regarding these comments.

Respectfully,

/s/ Stephen John Berger

Managing Director, Government & Regulatory Policy