FIA Principal Traders Group
2001 Pennsylvania Avenue NW
Suite 600 | Washington, DC 20006

T 202 466 5460
F 202 296 3184

ptg.fia.org

December 23, 2016

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

Re: Nasdaq Extended Life Priority Order Attribute under Rule 4703
Release No. 34-79428; File Number SR-NASDAQ-2016-161

Dear Mr. Fields:

The FIA Principal Traders Group ("FIA PTG")[1] appreciates the opportunity to comment on the proposal by the Nasdaq Stock Market, LLC ("Nasdaq") to introduce a new priority for displayed orders, the Extended Life Priority Order Attribute ("ELO") (the "Proposal").[2] For the reasons identified herein, we respectfully urge the Securities and Exchange Commission (the "Commission") to reject the Proposal.

Our comments below present a number of critical questions and concerns about the Proposal, including the introduction of increased complexity and associated costs to the U.S. equity markets, inequitable discrimination among market participants, lack of clarity around certain material provisions and chief among our concerns – the negative impact this Proposal would have on displayed liquidity. Far from benefitting investors, Nasdaq's ELO would reduce incentives for price discovery and price formation to the direct detriment of all market participants.

---

[1] FIA PTG is an association of more than 20 firms that trade their own capital on exchanges in futures, options and equities markets worldwide. FIA PTG members engage in manual, automated and hybrid methods of trading, and they are active in a wide variety of asset classes, including equities, fixed income, foreign exchange and commodities. FIA PTG member firms serve as a critical source of liquidity, allowing those who use the markets, including individual investors, to manage their risks and invest effectively. The presence of competitive professional traders contributing to price discovery and the provision of liquidity is a hallmark of well-functioning markets. FIA PTG advocates for open access to markets, transparency and data-driven policy and has previously made recommendations about a variety of equity market structure issues, including Regulation NMS (*see* https://ptg.fia.org/keywords/equity-market-structure).

[2] Exchange Act Release 79428 (Nov. 30, 2016), *available at* https://www.sec.gov/rules/sro/nasdaq/2016/34-79428.pdf.

BACKGROUND

As we wrote to the Commission in connection with the Investors' Exchange LLC's ("IEX") exchange application and accompanying proposed interpretation,[3] and the Chicago Stock Exchange, Inc. ("CHX") proposal[4] for an asymmetrical speed bump, we are concerned about the inevitable spiraling complexity that comes from multiple exchanges introducing different flavors of speed bumps across the market ecosystem. We explained how the IEX proposal and proposed interpretation "…risk[ed] turning the national market system into a hall of mirrors where it's impossible to know which prices are real and which are latent reflections."[5]

The Proposal differs from those put forth by IEX and CHX in that it does not introduce a speed bump applicable to all participants, but rather allows certain preferred participants to "jump-in-line" ahead of orders previously placed in Nasdaq's order book. Like IEX and CHX, however, this revised priority system negatively impacts the critical price discovery and formation functions of the exchange. The fact that three exchanges have put forth three such different proposals only serves to increase our concerns about equity market structure, which, like an untrimmed vine, continues to grow in complexity, choking off growth without producing any innovations that bear fruit.

THE PROPOSAL

The Proposal would "allow Displayed Orders that are committed to a one-second or longer resting period to receive higher priority than other Displayed Orders of the same price on the Nasdaq Book."[6] This fundamentally changes Nasdaq's order book queue priority from a price/display/time priority structure to a price/display/ELO/time priority. We find it interesting that while proposing to change the queue priority, Nasdaq accurately identifies the benefits of its existing price/display/time priority structure – increased competition, decreased bid/offer spreads, lower trading costs and democratization of market access. Various studies confirm these benefits.[7] In this context, Nasdaq's Proposal appears to be a solution in search of a problem.

---

[3] *See* Letter from Mary Ann Burns, Chief Operating Officer, FIA to Brett J. Fields, Secretary, Commission, dated April 14, 2016 (the "FIA PTG IEX Letter").

[4] *See* Letter from Joanna Mallers, Secretary, FIA PTG to Brett J. Fields, Secretary, Commission, dated October 13, 2016.

[5] *See* FIA PTG IEX Letter, *supra* note 3 at 2.

[6] *See* Proposal, *supra* note 2 at 2.

[7] *See, e.g.*, Angel, Harris and Spatt, *Equity Trading in the 21st Century: An Update*, (June 21, 2013) at 3 (stating "...traditional measures of market quality such as execution speed, bid-ask spreads, and transactions costs all had improved dramatically over time.") *at* http://www.q-group.org/wp-content/uploads/2014/01/Equity-Trading-in-the-21st-Century-An-Update-FINAL.pdf; Brogaard, Hendershott and Riordan, *High Frequency Trading and Price Discovery,* European Central Bank, Working Paper Series No. 1602 (Nov. 2013) at 34 (stating "Overall HFTs increase the efficiency of prices by trading in the direction of permanent price changes and in the opposite direction of transitory

FIA PTG supports experimentation and innovation and recognizes the value in considering whether new approaches can further improve favorable conditions. However, the benefits of this innovation would not outweigh the cost of added complexity and reduced price discovery. Moreover, exchange policies must comply with the law, which obliges the rejection of proposals that would disrupt fairness, orderliness, and efficiency. While the problems the Nasdaq Proposal seeks to address are hypothetical, the consequences of implementing the ELO "solution" would be quite real and problematic to the fair and orderly operation of our markets.

As proposed, ELO would be implemented in two phases. Phase One would be restricted to Designated Retail Orders. Phase Two would "extend the program to all Orders that meet the requirements of the Extended Life Priority Attribute after its successful implementation with Designated Retail Orders."[8]

Our comments address both phases of implementation. Our concerns with Phase One include discrimination among market participants, the potential to game ELO, the problems raised by information leakage, and the overall impact on price discovery. Our concerns with Phase Two include a lack of clarity on implementation details and the potential to add a great deal of complexity to markets without realizing many benefits.

COMMENTS ON PHASE ONE

Contravention of Section 6(b)(5) of the Securities Exchange Act of 1934

The first phase of the Proposal preferences a participant type by restricting ELO to Designated Retail Orders. As proposed, the idea of an "extended life order" is largely irrelevant to the impact of the Proposal during the first phase. This is because: (a) most retail participants do not cancel orders within one second; (b) Nasdaq would not be systematically enforcing the minimum order life requirement; and (c) the decision to classify order flow as ELO or non-ELO would not be made by the retail customers but rather by their brokers. The Proposal during the first phase would effectively allow retail orders to cut in line in front of existing orders.

Allowing only one type of market participant to use these orders is a departure from other exchange programs that apply to all market participants based on their choices of how to trade and what order types to use. In contravention of Section 6(b)(5) of the Securities Exchange Act of 1934, Nasdaq's ELO discriminates unnecessarily and unfairly among

---

pricing errors.") *at* https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1602.pdf; Charles M. Jones, *What do we know about high frequency trading?*, (Mar. 20, 2013) at 1 (stating "Based on the vast majority of the empirical work to date, HFT and automated, competing markets improve market liquidity, reduce trading costs, and make stock prices more efficient."), *at* http://online.wsj.com/public/resources/documents/HFT0324.pdf.

[8] *See* Proposal, *supra* note 2 at 8.

types of participants.[9] In so doing, it allows certain preferred participants to "jump-in-line" ahead of orders previously placed in Nasdaq's order book. Phase One discriminates unnecessarily and arbitrarily among types of participants and raises serious questions of fairness.[10]

Retail Definition and Gaming

In the event Nasdaq is permitted to move forward with Phase One of ELO, we strongly suggest that the current definition of Designated Retail Orders be honed and adjusted so as to capture a small, clear group of true retail investors.[11] If not, this would be a very risky change, as market participants would be heavily incented to test the boundaries of the rule to be able to gain the benefits of queue priority.

The proposed performance standards in Phase One also lack clarity. Nasdaq would "require that at least 99% of Designated Retail Orders with the Extended Life Priority Attribute exist unaltered on the Nasdaq Book for a minimum of one second."[12] There is not enough clarity on how this 99% threshold would be calculated or enforced.

As with all arbitrary quantitative thresholds, the 99% threshold provides an opportunity for gaming the system. In theory, a participant could determine the quantity of permissible ELO violations within the 1% by inflating the number of compliant ELO orders counted towards the 99% (*e.g.*, by placing multiple ELO orders away from the inside market). This could dramatically increase message traffic and bog down market data feeds.

---

[9] *See* 15 U.S.C. 78f(b)(5), which states that exchanges must not be "…designed to permit unfair discrimination between customers, issuers, brokers, or dealers."

[10] As Nasdaq said in its comment letter regarding the IEX exchange application, *"[i]nevitably, transmission latencies exist in electronic financial markets due to the laws of physics, geography, and the location decisions made by trading venues and market participants… **This does not mean, however, that the market and the terms of competition should be distorted through ad hoc changes that may disproportionately benefit one market participant**."* Letter from Joan C. Conley , Senior Vice President and Corporate Secretary, Nasdaq to Brett J. Fields, Secretary, Commission, dated January 29, 2016 at 4, *available at* https://www.sec.gov/comments/10-222/10222-350.pdf (Emphasis Added).

[11] Unfortunately, Nasdaq's definition of "retail" is very broad and many market participants who are not actually long-term, fundamental retail investors are likely to qualify as Designated Retail Orders. Furthermore, the Proposal expanded the definition of a Designated Retail Order to include orders placed by "natural persons" which can include corporations. In the absence of a more stringent or limited definition, we are concerned the potential for gaming the meaning of "retail" dramatically increases. While other exchange retail order flow programs rely on a similar definition of "retail order" and the riskless principal definition in FINRA Rule 5320.03, these programs do not provide a structural trading advantage as is proposed with ELO. Rather, they allow for fee or rebate advantages, which incentivize price improvement by market makers. We recommend clarifying the definition and implementing stronger controls around this definition to ensure that the integrity of the program is maintained. For instance, limitations around the maximum number of orders entered per day could further refine the definition of retail investors.

[12] *See* Proposal, *supra* note 2 at 8.

While we do not support the Proposal generally, we believe that if implemented, Nasdaq should be required to systematically enforce ELO performance standards. There is precedent for doing this – the Toronto Stock Exchange systematically enforces the minimum resting period by queuing cancels until the minimum resting period has passed.

Information Leakage

The Proposal also raises the potential for information leakage. Because ELO would be limited to Designated Retail Orders during Phase One, and ELO orders would be tagged as such in Nasdaq's market data feed, participants would be able to identify retail orders resting in the market. Through a simple process of elimination, market participants would also be able to identify the preponderance of other quotes as either coming from institutional investors or professional market makers. Publicly disseminating this information may lead to unintended consequences. However, not tagging ELO orders to avoid information leakage would make it impossible for liquidity providers to understand their place in the queue, and this uncertainty would inevitably result in wider spreads and smaller order size.

Overall Market Liquidity

Ultimately, the issues of discrimination, gaming, and information leakage are all contributing factors to our overarching concern with Phase One of the Proposal. The Nasdaq ELO would transform what is a deterministic and predictable order priority regime into one that is much less transparent and predictable. This fundamental change to its order ranking and execution system negatively impacts the critical price discovery and formation functions of the exchange—to the detriment of all participants.

Advantaging one type of participant over another would reduce the incentive for liquidity providers without ELO capability (*i.e.*, professional market makers) to set new price levels, as the risk taken when setting a new price level would be less likely to be rewarded. This added uncertainty for these participants directly increases their cost of quoting at the inside market and consequently would cause them to set new price levels less often and widen out their quotes. Wider markets generally mean an increased cost to trade for long-term investors, the very ones the Proposal is purported to benefit. Moreover, contrary to Nasdaq's belief that, "…if successful, the proposed change may bring greater stability to the Displayed quote and increase Displayed size…"[13] providing queue priority to one class of market participants and not others could materially disrupt the critical price discovery and liquidity functions performed by our markets.

COMMENTS ON PHASE TWO

[13] *See* Proposal, *supra* note 2 at 13.

The Proposal does not provide enough specific details on the design or implementation of Phase Two. For this reason, should the Commission, over our objections, decide to approve the Nasdaq ELO, we strongly recommend that the Commission require a detailed re-proposal of Phase Two prior to its implementation, including a public comment period. In conversations with our member firms, Nasdaq has acknowledged that the plans for Phase Two remain unclear, which only emphasizes the need for a re-proposal of this phase.

Because no further guidance is provided, it is to be assumed that Phase Two of ELO would be implemented for all participants with the same rules as have been proposed for Designated Retail Orders. The benefits of this order prioritization are unclear, but there are certain costs from the added complexity and reduced efficiency. It is entirely possible that as all market participants adjust their strategies to fully incorporate ELO, the value of the order attribute would essentially be competed away, leaving price/display/time as the determinant factors. The market would be returned, in essence, to the current competitive status quo—except with an additional complicated order type further adding to existing market complexity.

CONCLUSION

We believe the Proposal is fundamentally flawed because of the issues of discrimination, lack of clarity on key aspects, and the potential harm to liquidity and price discovery, all of which contribute to increased complexity and costs.

For these reasons, we respectfully urge the Commission to reject this flawed and discriminatory Proposal. At a minimum, the Commission should provide for more time for comments and feedback from Nasdaq to clarify the many unresolved questions raised by the Proposal.

If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact Joanna Mallers (jmallers@fia.org).

Respectfully,

FIA Principal Traders Group

Joanna Mallers
Secretary

cc: Mary Jo White, Chairwoman
Kara M. Stein, Commissioner
Michael S. Piwowar, Commissioner
Stephen Luparello, Director, Division of Trading & Markets