



8011-01
SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-80149; File No. SR-NASDAQ-2016-161)

March 3, 2017

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Amendment No. 1 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as Modified by Amendment No. 1, to Adopt a New Extended Life Priority Order Attribute under Rule 4703, and to Make Related Changes to Rules 4702, 4752, 4753, 4754, and 4757

I. Introduction

On November 17, 2016, the NASDAQ Stock Market LLC (“Exchange” or “Nasdaq”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt a new Extended Life Priority order (“ELO”) attribute for Designated Retail Orders under Nasdaq Rule (“Rule(s)”) 4703, and to make related changes to Rules 4702, 4752, 4753, 4754, and 4757. The proposed rule change was published for comment in the Federal Register on December 5, 2016.³ On January 17, 2017, pursuant to Section 19(b)(2) of the Act,⁴ the Commission designated a longer period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change.⁵ The Commission initially received

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 79428 (November 30, 2016), 81 FR 87628 (“Notice”).

⁴ 15 U.S.C. 78s(b)(2).

⁵ See Securities Exchange Act Release No. 79810, 82 FR 8244 (January 24, 2017). The Commission designated March 5, 2017 as the date by which the Commission shall approve or disapprove, or institute proceedings to determine whether to approve or disapprove, the proposed rule change.

seven comment letters on the proposed rule change.⁶ On February 17, 2017, the Exchange filed Amendment No. 1 to the proposed rule change⁷ and submitted a comment response letter.⁸ The Commission subsequently received one additional comment letter on the proposed rule change.⁹ The Commission is publishing this notice and order to solicit comments on the proposed rule change, as modified by Amendment No. 1, from interested persons and to institute proceedings

⁶ See Letters to Brent J. Fields, Secretary, Commission, from: Joseph Saluzzi and Sal Arnuk, Partners, Themis Trading LLC, dated December 19, 2016 (“Themis Letter”); Eric Swanson, EVP, General Counsel, and Secretary, Bats Global Markets, Inc., dated December 22, 2016 (“BATS Letter”); Adam Nunes, Head of Business Development, Hudson River Trading LLC, dated December 22, 2016 (“Hudson River Trading Letter”); Joanna Mallers, Secretary, FIA Principal Traders Group, dated December 23, 2016 (“FIA PTG Letter”); Adam C. Cooper, Senior Managing Director and Chief Legal Officer, Citadel Securities, dated December 27, 2016 (“Citadel Letter”); Andrew Stevens, General Counsel, IMC Financial Markets, dated December 28, 2016 (“IMC Letter”); and Venu Palaparthi, SVP, Compliance, Regulatory and Government Affairs, Virtu Financial LLC, dated February 9, 2017 (“Virtu Letter”).

⁷ In Amendment No. 1, the Exchange: (i) specified that the ELO attribute would be available during “System Hours” as defined in Rule 4701(g); (ii) clarified that any subsequent proposal to broaden the availability of the ELO attribute would be set forth in a distinct rule filing; (iii) provided additional details regarding the calculation of the 99% ELO eligibility requirement; (iv) proposed to assess members’ compliance with ELO eligibility requirements on a monthly basis instead of a quarterly basis as initially proposed; (v) stated that, concurrently with the initial launch of the ELO attribute, it will implement new surveillances to identify any potential misuse of the ELO attribute; (vi) provided additional discussions regarding the availability of the ELO identifier on the Exchange’s TotalView ITCH market data feed; (vii) provided additional details as to how the ELO attribute would operate with other order attributes and cross-specific order types; (viii) provided information regarding the Exchange’s implementation of the ELO attribute; and (ix) provided additional justifications for proposing the ELO attribute. Amendment No. 1 has been placed in the public comment file for SR-NASDAQ-2016-161 at <https://www.sec.gov/comments/sr-nasdaq-2016-161/nasdaq2016161-1589828-132168.pdf>.

⁸ See Letter to Brent J. Fields, Secretary, Commission, from T. Sean Bennett, Associate Vice President and Principal Associate General Counsel, Nasdaq, dated February 17, 2017 (“Nasdaq Response Letter”).

⁹ See Letter to Brent J. Fields, Secretary, Commission, from John Ramsay, Chief Market Policy Officer, Investors Exchange LLC, dated March 2, 2017 (“IEX Letter”).

pursuant to Section 19(b)(2)(B) of the Act¹⁰ to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposal, as Modified by Amendment No. 1

The Exchange has proposed to offer a new ELO attribute, which would allow certain displayed retail orders to receive higher priority on the Nasdaq book than other orders at the same price, and to make conforming changes to its rules. As discussed in more detail below, the Exchange has proposed to amend Rule 4703 to set forth the ELO attribute in new subparagraph (m), add an Attachment B to its Designated Retail Order Attestation Form that sets forth an attestation that would be required of members in connection with utilizing the ELO attribute, and make related changes to Rules 4702(b), 4752, 4753, 4754, and 4757.

Proposed Rule 4703(m) and Attestation

Proposed Rule 4703(m) states that ELO is an order attribute that allows an order to receive priority in the Nasdaq book above other orders resting on the Nasdaq book at the same price that are not designated with the ELO attribute.¹¹ As proposed, the ELO attribute would be available only for displayed orders that qualify as Designated Retail Orders,¹² and would be

¹⁰ 15 U.S.C. 78s(b)(2)(B).

¹¹ See also proposed changes to Rule 4757(a)(1)(B).

¹² See proposed Rule 4703(m). The term “Designated Retail Order” has the meaning set forth in Rule 7018. If a Designated Retail Order with a non-display attribute is also entered with the ELO attribute, the ELO attribute would be ignored and the order would be ranked on the Nasdaq book as a non-displayed order without Extended Life Priority. See id. The Exchange has stated that it anticipates extending the availability of the ELO functionality to all orders that meet the requirements of the ELO attribute. See Notice, 81 FR at 87630; see also Amendment No. 1. According to the Exchange, any such extension will be made through a separate filing with the Commission, and will likely require significant changes to the operation of the ELO attribute to account for the different participants eligible to use the attribute. See Amendment No. 1.

available during System Hours.¹³ A Designated Retail Order with the ELO attribute that is not marketable upon entry would be ranked on the Nasdaq book ahead of other displayed orders at the same price level that do not have the ELO attribute, but behind any other ELO orders at the same price level that the Exchange received previously.¹⁴

As proposed, in order for an Exchange member to be eligible to use the ELO attribute, at least 99% of the Designated Retail Orders with the ELO attribute entered by the participant must exist unaltered on the Nasdaq book for a minimum of one second.¹⁵ Exchange members would be required to submit a signed written attestation, in a form prescribed by Nasdaq, that they will comply with these eligibility requirements.¹⁶

For purposes of determining compliance with the 99% threshold, the Exchange would measure the number of orders with the ELO attribute that rested for one second or longer and divide that value by the number of orders that the member marked with the ELO attribute.¹⁷ Moreover, the one second time frame would begin at the time the ELO order is entered into the

¹³ See Amendment No. 1. See also Rule 4701(g) (defining “System Hours” to mean the period of time beginning at 4:00 a.m. ET and ending at 8:00 p.m. ET (or such earlier time as may be designated by Nasdaq on a day when Nasdaq closes early)).

¹⁴ See proposed Rule 4703(m); see also Notice, 81 FR at 87631.

¹⁵ See proposed Rule 4703(m). The Exchange has stated that it will monitor the effectiveness of the one-second minimum resting time and the 99% threshold, and will propose to adjust these requirements, as needed, in a new rule filing. See Amendment No. 1.

¹⁶ See proposed Rule 4703(m). The Exchange has proposed to amend its Designated Retail Order Attestation Form to add an Attachment B in order to require members to attest to compliance with the eligibility requirements for the ELO attribute, and to attest to their understanding of the penalties in cases of non-compliance. See proposed changes to the Designated Retail Order Attestation Form, included as Exhibit 3 to Amendment No. 1. As proposed, the Designated Retail Order Attestation Form would also inform members that they can designate certain order entry ports as “Retail Extended Life Order Ports” or tag each order as a “Retail Extended Life Order.” See *id.*

¹⁷ See Amendment No. 1.

Nasdaq book and would conclude once the order is removed from the Nasdaq book or modified by the participant or the Nasdaq system.¹⁸ As proposed, any change to an order that would currently result in the order losing priority (i.e., a change in the order's time stamp) would, if applied to an ELO order, be considered an alteration of the ELO order and stop the clock in terms of determining whether the order rested on the book unaltered for at least one second.¹⁹ In this vein, the Exchange stated that any type of update to an order that creates a new time stamp for priority purposes would count as a modification of the order and noted, by way of example, that each time an ELO order is updated due to pegging,²⁰ re-pricing, or reserve replenishment, the one-second timer would restart.²¹ The Exchange also stated that full cancellations would stop the timer.²² By contrast, a sub-second full or partial execution of an ELO order resting on the Nasdaq book would not count as an order modification or cancellation for purposes of determining compliance with the ELO eligibility requirements.²³ Likewise, a member's

¹⁸ See id. For an ELO order that Nasdaq routes upon receipt, the one second time frame would begin if and when the order returns to Nasdaq and is posted on the Nasdaq book. See id.

¹⁹ See id.

²⁰ The Exchange illustrated through an example that each time an ELO order with a primary or market pegging attribute has its price updated, it would be considered a new order for purposes of determining its resting time. See id. According to the Exchange, each price update would be considered a separate order for determining compliance with the ELO eligibility requirements. See id.

²¹ See id.

²² See id.

²³ See proposed Rule 4703(m); see also Amendment No. 1. According to the Exchange, a sub-second partial execution of an ELO order would be in compliance with the ELO eligibility requirement of one second. See Amendment No. 1. In addition, a sub-second partial execution of an ELO order would not reset the time from which the one second time frame is measured for the remainder of the order. See id.

reduction of the size of a resting ELO order prior to one second elapsing also would not count as an alteration for purposes of determining compliance with the ELO eligibility requirements.²⁴

As noted above, only displayed Designated Retail Orders would be eligible for the ELO attribute, and if a Designated Retail Order with a non-display attribute is also entered with the ELO attribute, the order would be added to the Nasdaq book as a non-displayed order without Extended Life Priority.²⁵ By way of example, the Exchange noted that an order with minimum quantity or midpoint pegging attributes would not be able to receive Extended Life Priority because an order with either of those attributes must be non-displayed.²⁶ The Exchange also noted that a reserve order has a displayed portion and non-displayed portion, and the displayed portion of a reserve order with the ELO attribute would be eligible to receive Extended Life Priority while the non-displayed portion of the order would not.²⁷ If the displayed portion of such an order receives a full execution, the displayed quantity would be replenished from the non-displayed reserve quantity, the newly-replenished displayed size would receive a new time stamp and Extended Life Priority based on that time stamp, and a new timer would start for purposes of determining compliance with the one second requirement.²⁸

As proposed, an order designated with the ELO attribute would only have Extended Life Priority if it is ranked at its displayed price. Specifically, proposed Rule 4703(m) would provide that an ELO order that is adjusted by the Exchange system upon entry to be displayed on the Nasdaq book at one price but ranked on the book at a different, non-displayed price would be

²⁴ See Amendment No. 1.

²⁵ See proposed Rule 4703(m); see also supra note 12.

²⁶ See Amendment No. 1.

²⁷ See id.

²⁸ See id.

ranked without the ELO attribute at the non-displayed price. If the Nasdaq system subsequently adjusts such an order to be displayed and ranked on the Nasdaq book at the same price, the order would be assigned Extended Life Priority and ranked on the book in time priority among other orders with Extended Life Priority at that price.²⁹

Additionally, proposed Rule 4703(m) would provide that, for purposes of the Nasdaq Opening, Closing, and Halt Crosses, all ELO orders on the Nasdaq book upon initiation of a Cross may participate in such a Cross and retain priority among orders posted on the Nasdaq book that also participate in the Cross. Upon initiation of a Cross, all ELO orders on the Nasdaq book that are eligible to participate in a Cross would be processed in accordance with Rule 4752 (Opening Process), Rule 4753 (Nasdaq Halt Cross), or Rule 4754 (Nasdaq Closing Cross), as applicable.³⁰ ELO orders that are held by the Nasdaq system for participation in the Opening or Closing Cross would not have Extended Life Priority in the Cross,³¹ but would be assigned Extended Life Priority if the order joins the Nasdaq book upon completion of the Cross.³² Any orders with Extended Life Priority that are not executed in a Cross would be ranked on the Nasdaq book with Extended Life Priority.³³

The Exchange has stated that it would carefully monitor members' use of the ELO attribute on a monthly basis and would not rely solely on a member's attestation with regard to

²⁹ See proposed Rule 4703(m).

³⁰ See id.

³¹ According to the Exchange, cross-specific orders marked with the ELO attribute would be eligible to participate in the Nasdaq Opening, Halt, and Closing Crosses, but they would be ranked for purposes of a cross execution without the ELO attribute. See Notice, 81 FR at 87631. By contrast, orders with the ELO attribute that are ranked on the Nasdaq book (i.e., orders that are in the continuous market) would retain Extended Life Priority for purposes of a cross execution. See id. See also Amendment No. 1.

³² See proposed Rule 4703(m).

³³ See id.

ELO usage.³⁴ The Exchange also has stated that it would determine whether a member was in compliance with the ELO eligibility requirements for a given month within five business days of the end of that month.³⁵ A member that does not meet the ELO eligibility requirements for any given month would be ineligible to receive Extended Life Priority for its orders in the month immediately following the month in which it did not comply.³⁶ Following the end of the ineligible month, a member would once again be able to enter ELO orders if it completes a new attestation.³⁷ If a member fails to meet the ELO eligibility requirements for a second time, its orders would not be eligible for Extended Life Priority for the two months immediately following the month in which it did not meet the eligibility requirements for the second time.³⁸ If a member fails to meet the ELO eligibility requirements for a third time, it would no longer be eligible to receive Extended Life Priority for its orders.³⁹ In addition, concurrently with the initial launch of the ELO attribute, the Exchange would implement new surveillance to identify any potential misuse of the ELO attribute.⁴⁰ Moreover, any attempted manipulation or

³⁴ See Amendment No. 1.

³⁵ See id.

³⁶ See id.; see also proposed new Attachment B to the Exchange's Designated Retail Order Attestation Form at Exhibit 3 to Amendment No. 1. Nasdaq has stated that its system would prevent a member that is not eligible to participate in the program from entering orders that are flagged with Extended Life Priority (including such designation on the port level). See Notice, 81 FR at 87630 n.17.

³⁷ See Amendment No. 1; see also proposed new Attachment B to the Exchange's Designated Retail Order Attestation Form at Exhibit 3 to Amendment No. 1.

³⁸ See Amendment No. 1; see also proposed new Attachment B to the Exchange's Designated Retail Order Attestation Form at Exhibit 3 to Amendment No. 1.

³⁹ See Amendment No. 1; see also proposed new Attachment B to the Exchange's Designated Retail Order Attestation Form at Exhibit 3 to Amendment No. 1.

⁴⁰ See Amendment No. 1.

misrepresentation of the nature of an ELO order (e.g., representing a non-retail order to be a Designated Retail Order) would be a violation of Nasdaq's rules.⁴¹

The Exchange has proposed to designate orders with the ELO attribute with a new, unique identifier.⁴² Specifically, orders with the ELO attribute may be individually designated with the new identifier, or may be entered through an order port that has been set to designate, by default, all orders with the new identifier.⁴³ Orders marked with the new identifier – whether on an order-by-order basis or via a designated port – would be disseminated via Nasdaq's TotalView ITCH data feed.⁴⁴

Additional Conforming Rule Changes

In connection with the proposed addition of Rule 4703(m), the Exchange has proposed to make conforming changes to Rules 4702(b)(1)(C), (b)(2)(C), and (b)(4)(C) to indicate that the ELO attribute may be assigned to price to comply, price to display, and post-only orders, respectively. In addition, the Exchange has proposed to amend Rules 4752 (Opening Process), 4753 (Nasdaq Halt Cross), and 4754 (Nasdaq Closing Cross) to incorporate ELO orders into the cross execution priority hierarchies set forth in each of those rules.

Implementation

⁴¹ See *id.* According to Nasdaq, like the current surveillance it conducts, the new surveillance would identify potential violative conduct that would be investigated by Nasdaq and FINRA, and if the conduct is found to be violative, the offending member would be subject to disciplinary action. See Amendment No. 1 (citing the Nasdaq Rule 9000 Series).

⁴² See Notice, 81 FR at 87630-31; see also proposed new Attachment B to the Exchange's Designated Retail Order Attestation Form at Exhibit 3 to Amendment No. 1.

⁴³ See Notice, 81 FR at 87630-31; see also proposed new Attachment B to the Exchange's Designated Retail Order Attestation Form at Exhibit 3 to Amendment No. 1.

⁴⁴ See Notice, 81 FR at 87630-31. The Exchange is not proposing to disseminate the ELO identifier via the SIP data feeds. See Amendment No. 1.

The Exchange has stated that it plans to implement the ELO functionality for Designated Retail Orders in a measured manner.⁴⁵ Specifically, the Exchange anticipates a rollout of the ELO functionality, beginning with a small set of symbols and gradually expanding further, and that it will publish the symbols that are eligible for the ELO attribute on its website.⁴⁶ According to the Exchange, the exact implementation date would be reliant on several factors, such as the results of extensive testing and industry events and initiatives.⁴⁷ The Exchange currently plans to implement the initial set of symbols for ELO in the third quarter of 2017.⁴⁸

III. Summary of Comments and Nasdaq's Response

The Commission received eight comment letters that expressed concerns with respect to the proposed rule change,⁴⁹ and one response letter from the Exchange.⁵⁰ Commenters' concerns are focused on: (1) the availability of the ELO attribute only to retail orders; (2) the eligibility requirements for the ELO attribute, including the effectiveness of the attestation requirement and the Exchange's methods for monitoring compliance and imposing discipline for non-compliance; (3) the potential market impact of the proposal; (4) the potential for information leakage from the identification of ELO orders in Nasdaq's market data feed; and (5) the potential conflict between the proposed ELO eligibility requirements and other activities of the member.

⁴⁵ See Amendment No. 1.

⁴⁶ See id. The Exchange noted that, in symbols that are not eligible for ELO functionality, it will accept orders submitted with the ELO attribute as non-ELO orders. See id.

⁴⁷ See id.

⁴⁸ See id. The Exchange stated that it will notify market participants via an Equity Trader Alert once a specific date for the initial rollout is determined. See id. For a more detailed description of the proposed rule change, see Amendment No. 1.

⁴⁹ See supra notes 6 and 9. The IMC Letter broadly supported the comments articulated in the FIA PTG Letter and did not provide additional comments on the proposed rule change.

⁵⁰ See supra note 8.

A. Availability of the ELO Attribute Only to Designated Retail Orders

Three commenters expressed concern that the Exchange's proposal would provide the ELO functionality only to retail orders.⁵¹ One commenter argued that the proposal would effectively allow retail orders to cut in line in front of existing orders.⁵² Another commenter argued that the proposal would unfairly burden competition because it would allow the Exchange to compete for order flow by creating an order attribute that inappropriately favors certain market participants at the expense of others.⁵³ These commenters also argued that the proposal is unnecessary, stating that there is insufficient evidence that retail investors are experiencing difficulty in obtaining fills for resting orders and therefore would benefit from the proposed functionality.⁵⁴

In response to comments, the Exchange stated its belief that the growth in internalization and the speed of execution has required differentiation of retail orders, which are typically entered by long-term investors, from those of other market participants.⁵⁵ The Exchange also noted that the proposal is an effort to promote displayed orders with longer time horizons to

⁵¹ See FIA PTG Letter at 3-4; Hudson River Trading Letter at 2; Citadel Letter at 5-6. Three commenters also expressed general concerns with respect to the potential expansion of the ELO functionality beyond retail orders, or noted that their concerns regarding the enhanced priority provided to retail orders under the proposal could be exacerbated in connection with any such expansion. See BATS Letter at 1; Citadel Letter at 6; FIA PTG Letter at 6. In response to these concerns, the Exchange noted that any future expansion of the ELO functionality beyond retail orders would be subject to a separate rule filing with the Commission. See Nasdaq Response Letter at 7. See also Amendment No. 1.

⁵² See FIA PTG Letter at 3-4. This commenter noted that most retail participants do not cancel orders within one second, Nasdaq would not be systematically enforcing the minimum order life requirement, and the decision whether to classify order flow as ELO would be made by brokers, not their retail customers. See *id.* at 3.

⁵³ See Citadel Letter at 4.

⁵⁴ See FIA PTG Letter at 2-3; Citadel Letter at 1-2.

⁵⁵ See Amendment No. 1.

enhance the market so that it works for a wider array of market participants, and the proposal will benefit publicly traded companies by promoting long-term investment in corporate securities.⁵⁶ In addition, the Exchange noted that providing the proposed ELO functionality to retail investors would help improve execution quality and retail participation in on-exchange transactions, which would improve overall market quality on the Exchange.⁵⁷ The Exchange also noted that the proposal would provide firms handling retail order flow with additional options to consider when determining the best way to represent and execute retail non-marketable limit orders.⁵⁸ According to the Exchange, the proposal may lead to improved execution quality for not only retail orders, but also those orders that interact with retail orders.⁵⁹

B. Eligibility Requirements and Exchange Monitoring

Four commenters expressed concern that the Exchange's initial proposal to monitor for compliance with the ELO eligibility requirements on a quarterly basis is insufficient to appropriately surveil for misuse of the functionality.⁶⁰ Two of these commenters advocated for stronger or more immediate penalties for failure to comply with the ELO eligibility requirements.⁶¹ Specifically, one commenter stated that the Exchange should describe how it would monitor for and penalize abuse intra-quarter, and that the proposal does not impose strong enough penalties to deter abuse.⁶² The other commenter proposed that the Exchange conduct weekly reviews and that a participant be prohibited from utilizing the ELO functionality after

⁵⁶ See Nasdaq Response Letter at 2.

⁵⁷ See Nasdaq Response Letter at 3 and 7.

⁵⁸ See id. at 3.

⁵⁹ See Amendment No. 1.

⁶⁰ See BATS Letter at 1-2; Citadel Letter at 4; Themis Letter at 2-3; Virtu Letter at 2.

⁶¹ See BATS Letter at 2; Virtu Letter at 2.

⁶² See BATS Letter at 2.

only two weeks of non-compliance.⁶³ In addition, one commenter suggested that the Exchange should systematically enforce the one second resting time for ELO orders,⁶⁴ and one commenter suggested that the Exchange should code a one second minimum duration into the ELO attribute.⁶⁵

Three commenters argued that, under the proposed attestation requirement, a participant could game the 99% threshold by improperly inflating its number of compliant ELO orders, such as by submitting a large number of non-marketable ELO Orders, while impermissibly benefiting from its non-compliant 1% of ELO Orders.⁶⁶ One of these commenters also stated that the Exchange has not provided sufficient clarity regarding how it would calculate whether at least 99% of a member's ELO orders have rested unaltered on the Nasdaq book for a minimum of one second.⁶⁷

Moreover, two commenters expressed concern that the Exchange has not sufficiently limited the definition of "Designated Retail Order" for purposes of the proposed functionality to truly capture retail investors and to prevent misuse of the definition.⁶⁸

In response, the Exchange amended its proposal, among other things, to add additional detail regarding the ELO functionality, including how the proposed one-second timer would operate and how the 99% threshold would be calculated, as well as to shorten the review period for determining compliance with the eligibility requirements from a quarterly review to a

⁶³ See Virtu Letter at 2.

⁶⁴ See FIA PTG Letter at 5.

⁶⁵ See Themis Letter at 3.

⁶⁶ See FIA PTG Letter at 4; Citadel Letter at 6; IEX Letter at 2.

⁶⁷ See FIA PTG Letter at 4.

⁶⁸ See FIA PTG Letter at 4; Citadel Letter at 4-5.

monthly review period.⁶⁹ The Exchange also stated that it believes its proposed 99% threshold is appropriate, noting that the standard would require “near perfect performance” while allowing some flexibility in the event any unforeseen issues may result in de minimis non-compliance.⁷⁰ Further, the Exchange stated that it would establish new surveillance to detect potential misuse of the proposed functionality and noted that any attempt to game or otherwise abuse the ELO functionality would be a violation of the Exchange’s rules and would subject the member to potential disciplinary action.⁷¹

Moreover, the Exchange stated that the definition of Designated Retail Order is clear that the member entering such an order must have policies and procedures designed to ensure that the order complies with the requirements of the definition, including that the order originate from a natural person.⁷² The Exchange also stated that the definition of Designated Retail Order allows for orders to originate from organizations in very limited circumstances.⁷³ The Exchange noted that, accordingly, it does not believe that there is latitude for a member to legally represent itself

⁶⁹ See Nasdaq Response Letter at 4 and Amendment No. 1. See also supra notes 17-24 and 34-39 and accompanying text. One commenter noted that this increased frequency of monitoring did not address its concerns with the Exchange’s proposed monitoring and enforcement mechanisms. See IEX Letter at 3.

⁷⁰ See Nasdaq Response Letter at 4.

⁷¹ See id. See also supra notes 40-41 and accompanying text. One commenter noted that the Exchange has not offered any specifics about this proposed new surveillance. See IEX Letter at 2. This commenter also noted that the proposed penalties for misuse of the ELO attribute would not address the problem that other market participants that traded with noncompliant ELO orders were doing so under false assumptions. See id. at 2-3.

⁷² See Nasdaq Response Letter at 6. See also Nasdaq Rule 7018 (defining “Designated Retail Order”).

⁷³ See Nasdaq Response Letter at 6.

as eligible to enter an order with ELO priority when the order does not fit within the definition of Designated Retail Order.⁷⁴

C. Potential Market Impact

Two commenters expressed concern that the proposal would create uncertainty regarding the priority of resting orders, and would negatively impact market liquidity and price discovery.⁷⁵ According to these commenters, the increased uncertainty among liquidity providers would result in wider spreads, which would adversely impact long-term investors, including institutional and retail investors.⁷⁶ One of these commenters also noted that the proposal would negatively impact market makers' hedging strategies in ETFs and their underlying securities, and the associated risk and cost would be borne by institutional and retail investors.⁷⁷ Another commenter argued that ELO orders should not receive priority over other orders that have already been resting for at least one second, and that doing so would discourage other market participants from displaying liquidity.⁷⁸

In response, the Exchange noted its belief that markets and price discovery best function through the interactions of a diverse set of market participants.⁷⁹ Moreover, the Exchange noted that providing a mechanism by which retail orders may have an increased chance of execution on the Exchange will promote competition among the Exchange, its exchange peers, and off-

⁷⁴ See id.

⁷⁵ See Citadel Letter at 3-4; FIA PTG Letter at 5.

⁷⁶ See Citadel Letter at 3-4; FIA PTG Letter at 5.

⁷⁷ See Citadel Letter at 3.

⁷⁸ See Hudson River Trading Letter at 2-3.

⁷⁹ See Amendment No. 1.

exchange trading venues.⁸⁰ According to the Exchange, if the proposal does not ultimately improve market quality, market participants may send their orders elsewhere.⁸¹

D. Potential for Information Leakage

Four commenters expressed concern that the proposed ELO order identifier on Nasdaq's TotalView ITCH market data feed would cause information leakage by revealing to market participants that certain orders are retail orders and must remain unaltered for at least one second.⁸² Two of these commenters noted that, through the process of elimination, market participants also would be able to identify the preponderance of other quotes as coming from institutions or professional market makers.⁸³ One of these commenters also contended, however, that not tagging ELO orders would prevent liquidity providers from being able to identify their place in the queue, and that this uncertainty would lead to wider spreads and smaller order size.⁸⁴

The Exchange acknowledged that information leakage is a concern for some non-retail market participants who may build or unwind significant trading positions or engage in proprietary and confidential trading strategies, and that it may be an issue if the ELO attribute were to be applied as currently proposed to non-retail market participant orders.⁸⁵ The Exchange stated that it does not believe that information leakage is a concern with respect to the current proposal because the ELO functionality would be available only to retail orders, and retail

⁸⁰ See Nasdaq Response Letter at 7.

⁸¹ See id. at 3 and Amendment No. 1. The Exchange stated that while Regulation NMS may dictate that the best displayed price must be accessed before executing at an inferior price, it does not dictate that an order must be displayed on Nasdaq. See Nasdaq Response Letter at 3.

⁸² See Citadel Letter at 5; FIA PTG Letter at 5; Themis Letter at 1-2; IEX Letter at 1-2.

⁸³ See FIA PTG Letter at 5; IEX Letter at 1-2.

⁸⁴ See FIA PTG Letter at 5.

⁸⁵ See Nasdaq Response Letter at 6.

investor interest is most often represented by one order at a single price.⁸⁶ In addition, according to the Exchange, the identification of ELO orders in the Exchange's TotalView ITCH market data feed would provide transparency that would be valuable for the industry in evaluating the efficacy of the proposal.⁸⁷

E. Potential Conflict with Other Activities of a Member

One commenter suggested that the proposal could conflict with FINRA Rule 5320, commonly known as the Manning rule, which may require a broker-dealer to fill held customer orders in certain circumstances within one second of receiving the order.⁸⁸ The commenter stated that, in this situation, the broker-dealer would have to cancel the customer's resting order on Nasdaq to prevent the customer from receiving a duplicative fill.⁸⁹ According to the commenter, if this cancellation occurred within one second of the broker-dealer routing a customer ELO order to Nasdaq, the broker-dealer's efforts to comply with its FINRA Rule 5320 obligations would potentially render the broker-dealer out of compliance with the ELO requirements.⁹⁰ The commenter further contended that it expects this scenario to occur

⁸⁶ See id. at 6-7. One commenter noted that Nasdaq's response does not address the concern that the ELO identifier could help market participants identify institutional investor orders. See IEX Letter at 1-2.

⁸⁷ See Nasdaq Response Letter at 7.

⁸⁸ See Citadel Letter at 2. FINRA Rule 5320(a) states that "[e]xcept as provided herein, 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."

⁸⁹ See Citadel Letter at 2.

⁹⁰ See id.

frequently in very liquid stocks.⁹¹ In addition, the commenter asserted that, if a broker-dealer cannot meet the 99% threshold due to its FINRA Rule 5320 obligations, that broker-dealer's non-ELO customer limit orders would be disadvantaged as compared to other broker-dealers' retail customer limit orders that could utilize the ELO attribute.⁹²

This commenter also expressed concern that an Exchange member may receive a sub-second cancellation request from a customer, which could cause the member to fall under the 99% threshold and become ineligible to submit ELO orders on behalf of other customers.⁹³

In response, the Exchange argued that the Manning obligations of a member using the ELO functionality would be no different from the obligations on an OTC market maker that internalizes orders and relies on the "no-knowledge" exception to separate its proprietary trading from its handling of customer orders.⁹⁴ The Exchange stated that this exception should be equally applicable to a member using the ELO functionality.⁹⁵

The Exchange also noted that it believes that retail investor limit orders that are posted on the Exchange will generally not be cancelled in a short period of time such as one second, because retail investors tend to have long-term investment goals and increasing the chance of receiving an execution is worth the risk of their order resting for one second or longer.⁹⁶

⁹¹ See id.

⁹² See id.

⁹³ See id. at 5.

⁹⁴ See Nasdaq Response Letter at 5. See also Supplementary Material .02 to FINRA Rule 5320.

⁹⁵ See Nasdaq Response Letter at 5.

⁹⁶ See id. at 4.

IV. Proceedings to Determine Whether to Approve or Disapprove SR-NASDAQ-2016-161, as Modified by Amendment No. 1, and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act⁹⁷ to determine whether the proposed rule change, as modified by Amendment No. 1, should be approved or disapproved. Institution of proceedings is appropriate at this time in view of the legal and policy issues raised by the proposal, as discussed below. Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described below, the Commission seeks and encourages interested persons to provide additional comment on the proposed rule change, as modified by Amendment No. 1.

Pursuant to Section 19(b)(2)(B) of the Act,⁹⁸ the Commission is providing notice of the grounds for disapproval under consideration. As discussed above, the Exchange has proposed to offer a new ELO attribute, which would only be available to Designated Retail Orders and would allow an order to receive priority in the Nasdaq book above other orders resting on the Nasdaq book at the same price that are not designated with the ELO attribute. The Commission is instituting proceedings to allow for additional analysis of, and input from commenters with respect to, the consistency of the proposed rule change, as modified by Amendment No. 1, with Section 6(b)(5) of the Act,⁹⁹ which requires that the rules of a national securities exchange be designed, among other things, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest, and not be designed to permit

⁹⁷ 15 U.S.C. 78s(b)(2)(B).

⁹⁸ Id.

⁹⁹ 15 U.S.C. 78f(b)(5).

unfair discrimination between customers, issuers, brokers, or dealers; and Section 6(b)(8) of the Act,¹⁰⁰ which requires that the rules of a national securities exchange not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

V. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their data, views, and arguments with respect to the issues identified above, as well as any other concerns they may have with the proposal. In particular, the Commission invites the written views of interested persons concerning whether the proposed rule change, as modified by Amendment No. 1, is consistent with Section 6(b)(5), 6(b)(8), or any other provision of the Act, or the rules and regulations thereunder. Although there does not appear to be any issues relevant to approval or disapproval which would be facilitated by an oral presentation of data, views, and arguments, the Commission will consider, pursuant to Rule 19b-4 under the Act,¹⁰¹ any request for an opportunity to make an oral presentation.¹⁰²

Interested persons are invited to submit written data, views, and arguments regarding whether the proposed rule change, as modified by Amendment No. 1, should be approved or disapproved by [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 35

¹⁰⁰ 15 U.S.C. 78f(b)(8).

¹⁰¹ 17 CFR 240.19b-4.

¹⁰² Section 19(b)(2) of the Act, as amended by the Securities Acts Amendments of 1975, Pub. L. 94-29 (June 4, 1975), grants to the Commission flexibility to determine what type of proceeding – either oral or notice and opportunity for written comments – is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Acts Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

days from publication in the Federal Register]. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. SR-NASDAQ-2016-161 on the subject line.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File No. SR-NASDAQ-2016-161. The file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File No. SR-NASDAQ-2016-161 and should be submitted by [insert date 21 days from the date of publication in the Federal Register]. Rebuttal comments should be submitted by [insert date 35 days from date of publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁰³

Eduardo A. Aleman
Assistant Secretary

¹⁰³ 17 CFR 200.30-3(a)(12); 17 CFR 200.30-3(a)(57).

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