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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-85351; File No. SR-IEX-2018-23]

Self-Regulatory Organizations; Investors Exchange LLC; Notice of Filing of Amendment No. 1, and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Modify the Resting Price of Discretionary Peg Orders

March 18, 2019

I. Introduction

On November 30, 2018, the Investors Exchange, LLC (“IEX” or “Exchange”) 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 modify the resting price of Discretionary Peg orders. The proposed rule change was published for comment in the Federal Register on December 19, 2018.³ The Commission received two comments on the proposed rule change,⁴ and one response letter from the Exchange.⁵ On March 13, 2018, the Exchange filed Amendment No. 1 to the proposed rule change.⁶ The Commission

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 84820 (December 13, 2018), 83 FR 65186 (December 19, 2018) (“Notice”).

⁴ See Letters from Joanna Mallers, Secretary, FIA Principals Traders Group to Brent J. Fields, Secretary, Office of the Secretary, Commission, dated January 22, 2019 (“FIA PTG Letter I”) and March 1, 2019 (“FIA PTG Letter II”).

⁵ See Letter from John Ramsey, Chief Market Policy Officer, IEX Group, Inc. to Brent J. Fields, Secretary, Office of the Secretary, Commission, dated February 14, 2019 (“IEX Letter”).

⁶ In Amendment No. 1, the Exchange specified that, if the Commission were to approve its proposed rule change, the Exchange would implement it within ninety (90) days of Commission approval and would provide market participants with at least 10 days of notice via a Trading Alert once a specific implementation date is determined. To promote transparency of its proposed amendment, when the Exchange filed Amendment No. 1 with the Commission, it also submitted Amendment No. 1 as a comment letter to the file, which the Commission posted on its website and placed in the public comment file for SR-IEX-2018-23 (available at <https://www.sec.gov/comments/sr-iex-2018-23/sriex201823-5101841-183253.pdf>). The Exchange also posted a copy of its

is publishing this notice to solicit comments on Amendment No. 1 from interested persons, and is approving the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

II. Description of the Proposed Rule Change

The Exchange offers a Discretionary Peg order type that is an entirely non-displayed, pegged order.⁷ Upon entry, the order is priced by the IEX system to be equal to the less aggressive of the midpoint of the NBBO or the order's limit price, if any. Currently, any unexecuted portion of the order is posted and ranked non-displayed on the IEX order book at the near-side primary quote (i.e., the NBB for buy orders, the NBO for sell orders). Thereafter, the resting price of the order is automatically adjusted by the IEX system in response to changes in the NBB (NBO) for buy (sell) orders so that its non-displayed resting price remains pegged at the near-side primary quote, up (down) to the order's limit price, if any.⁸

Once posted to the IEX order book, a Discretionary Peg order, in response to incoming active orders, will exercise the least amount of price discretion necessary from its resting price to its discretionary price, and thus may trade more aggressively up to (for buy orders) or down to (for sell orders) the midpoint of the NBBO,⁹ but will only do so when the IEX system determines the quote in the subject security to be "stable."¹⁰ When IEX determines the quote to be "unstable" for the

Amendment No. 1 on its website.

⁷ The Exchange currently offers three types of pegged orders – primary peg, midpoint peg, and Discretionary Peg – each of which are non-displayed orders that are pegged to a reference price based on the national best bid and offer ("NBBO"). See IEX Rule 11.190(a)(3).

⁸ See IEX Rule 11.190(b)(10).

⁹ When "exercising discretion," a Discretionary Peg order is prioritized behind any displayed or non-displayed interest resting at the discretionary price. See IEX Rule 11.190(b)(10).

¹⁰ See IEX Rule 11.190(g).

subject security and activates the crumbling quote indicator (“CQI”) for up to 2 milliseconds, as specified in IEX Rule 11.190(g), Discretionary Peg orders do not exercise price discretion to trade at prices to the midpoint of the NBBO. However, Discretionary Peg orders remain eligible for execution at their resting price (i.e., at the NBB (NBO) for buy (sell) orders) when the CQI is on. Therefore, when IEX determines the quote to be unstable, Discretionary Peg orders are protected from trading more aggressively to a reference price that IEX determines may become stale imminently.

In its proposal, the Exchange now proposes to modify the resting price of Discretionary Peg orders to be equal to the less aggressive of 1 MPV less aggressive than the primary quote (rather than the primary quote itself) or the order’s limit price. The Exchange notes that the proposed resting price for Discretionary Peg orders will be the same as the resting price of primary peg orders pursuant to IEX Rule 11.190(b)(8).¹¹

In its filing, the Exchange stated that one of the purposes for its proposed rule change was to “further protect resting Discretionary Peg orders from execution at a stale price” and noted that Discretionary Peg orders currently “remain susceptible to trading at the primary quote” when the CQI is on.¹² The Exchange further noted that, in its experience, while Discretionary Peg orders do not often execute at the primary quote, a considerable portion of such executions at the primary quote occur when the CQI is on.¹³

Finally, the Exchange also proposes conforming changes to the description of the resting

¹¹ See Notice, supra note 3, at n.12.

¹² See id. at 65187.

¹³ See id. (observing that in May-June 2018, “90% of Discretionary Peg order executions trade within the NBBO when the CQI is off, 88% of which execute at the Midpoint Price. However, of the remaining 10% of Discretionary Peg order executions that occur at the primary quote, 31% occur when the CQI is on”).

price of Discretionary Peg orders for purposes of ranking and priority in the Regular Market Session Opening Process for Non-IEX-Listed Securities and IEX Auctions.¹⁴

III. Comment Letter and Exchange Response

The Commission received two comments from one commenter that opposed the proposal rule change.¹⁵ The commenter expressed concern that IEX's proposal would allow a Discretionary Peg order to "jump over" other orders to price more aggressively up to the midpoint when the CQI signal indicates it is "safe" to do so, but IEX will "reprice" the order back below the near-side primary quote "to avoid execution" (emphasis in original) when the CQI signal indicates a potential unstable quote.¹⁶

The commenter stated that, as a result of IEX's proposed rule change, "the Discretionary Peg [o]rder can avoid being executed at all whenever the CQI signal is active"¹⁷ and noted that current Discretionary Peg functionality to price more aggressively when the CQI is off "is partly counterbalanced by the fact that even when the CQI signal is active, Discretionary Peg [o]rders will still be executed."¹⁸ The commenter argued that the proposal "would be eliminating this counterbalance" as a Discretionary Peg order would "never" execute when the CQI "predicted an imminent price change in the NBBO."¹⁹ In turn, the commenter believed that the proposal presents a "conflict between the proposed change and the promotion of price discovery through

¹⁴ See proposed IEX Rule 11.231(a)(1)(iii) and IEX Rule 11.350(b)(1)(A)(i)(c), respectively.

¹⁵ See supra note 4.

¹⁶ See FIA PTG Letter I, supra note 4, at 2.

¹⁷ See id.

¹⁸ See id.

¹⁹ See id.

the display of protected quotes.”²⁰

In its second letter, the commenter noted that a Discretionary Peg order is “much more likely to be exercising discretion than not” as they are “eligible to trade more aggressively throughout the entire day with the exception of the 1.24 seconds when IEX has determined the market is unstable” (emphasis in original).²¹ The commenter also noted that the merits of the proposal are subjective and “depend on the perspective from which the order is viewed.”²² For example, while IEX views the proposal as providing an additional measure of protection to Discretionary Peg orders when the CQI is on, “[f]rom the point of view of the seller, the [Discretionary Peg order] appears to have faded its interest in response to preferential access to market data.”²³ The commenter further criticized the Exchange’s lack of data or analysis on the impact that its proposal might have on the provision of displayed liquidity on IEX.²⁴

In its response, the Exchange stated its belief that the commenter described aspects of the Discretionary Peg order inaccurately.²⁵ In particular, the Exchange disagreed that Discretionary Peg orders “fall back” or reprice passively when the CQI is on, but rather characterized them as resting passively when the CQI is active.²⁶ Thus, the Exchange

²⁰ See id. The commenter also urged the Commission to establish standards or guidelines for the use of discretionary price mechanisms and the ability of matching engines to adjust order prices based on predictive signals, and posed several hypothetical order types that could introduce additional complexity and potential conflicts between order types. See id. at 3.

²¹ See FIA PTG Letter II, supra note 4, at 2.

²² See id.

²³ See id.

²⁴ See id.

²⁵ See IEX Letter, supra note 4, at 2.

²⁶ See id.

characterized the proposal as “rather than repricing when the CQI is active, IEX is simply proposing that [Discretionary Peg orders] rest more passively” than they do currently (emphasis in original).²⁷

The Exchange also argued that the commenter mischaracterized the operation of the Discretionary Peg order by suggesting it could “jump over” resting displayed orders.²⁸ The Exchange explained that a Discretionary Peg order “exercise[s] the least amount of price discretion necessary from [its] resting price to its discretionary price,” except during periods of quote instability, and “is prioritized behind any displayed or non-displayed interest resting at the discretionary price.”²⁹ Thus, the Exchange explained that Discretionary Peg orders can only trade at prices more aggressive than resting displayed orders (i.e., at the midpoint) only when the active incoming order is priced less aggressive than the NBBO (i.e., active sell orders priced higher than the NBB or active buy orders priced lower than the NBO) (emphasis in original).³⁰

Further, the Exchange countered the commenter’s assertion that, unlike displayed orders, Discretionary Peg orders would never be eligible to execute when the CQI is active. The Exchange explained that a Discretionary Peg order would remain eligible to trade at its proposed resting price when the active order is priced more aggressive than the NBBO.³¹

Finally, the Exchange stated its belief that its proposed change did not present a novel

²⁷ See id.

²⁸ See id.

²⁹ See id.

³⁰ See id.

³¹ See id. In its second comment letter, FIA PTG acknowledged this point but argued that it is unlikely to occur because it believes “it is not common practice to route through the NBBO into the depth of book.” See FIA PTG Letter II, supra note 4, at n. 3.

application of discretionary pricing.³²

IV. Discussion and Commission Findings

After careful review of the proposal and the comments received thereon the Commission finds that the proposed rule change is consistent with the requirements of the Act³³ and the rules and regulations thereunder applicable to a national securities exchange.³⁴ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,³⁵ which requires that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, 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.

The Commission believes the proposed rule change is consistent with the protection of investors and the public interest because it is reasonably designed to protect non-displayed resting Discretionary Peg orders from unfavorable executions when IEX's precise rules-based mathematical quote instability formula suggests the possibility that the market may soon move against them in the next two milliseconds. If the market does move, the Discretionary Peg orders are re-ranked at a new resting price and permitted to once again exercise discretion to meet the limit price of active orders.

In general, the core design of a Discretionary Peg order, when resting, is to provide

³² See IEX Letter, supra note 4, at 3.

³³ 15 U.S.C. 78f.

³⁴ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

³⁵ 15 U.S.C. 78f(b)(5).

liquidity at a price as aggressive as the midpoint of the NBBO. While such orders currently rest at the near-side quote, these orders are non-displayed (i.e., not reflected in the near-side quote) and thus market participants do not know in advance whether or to what extent they may be present on IEX. Further, such orders are ranked behind other interest, and they exercise the least amount of price discretion necessary in response to an incoming active order. As the Exchange continuously updates the NBBO and calculates the midpoint thereof, it also applies its CQI functionality in an attempt to predict an in-process market move that could result imminently in a new midpoint price. In ranking a Discretionary Peg order at its resting price during this time, investors may be better able to achieve their goals of passively trading up to the most up-to-date midpoint while minimizing the adverse selection of their non-displayed interest.

The proposed change will result in Discretionary Peg orders resting at the less aggressive of one MPV less aggressive than the primary quote (or the order's limit price), rather than the primary quote itself. As these order types are non-displayed, the Commission disagrees with the commenter's assertion that, from the perspective of a seller, a Discretionary Peg order can appear to have faded its interest. As such orders are non-displayed, they cannot so appear.

Rather, resting a Discretionary Peg order at one MVP less aggressive than it currently rests is reasonably designed to further protect such orders from execution at potentially stale prices, and therefore may help users of such orders avoid subjecting them to "latency arbitrage" by those market participants using very sophisticated latency-sensitive technology who can rapidly aggregate market data feeds and react fast to changing market conditions.³⁶ As IEX notes, Discretionary Peg orders will remain subject to execution at their new, only slightly less aggressive,

³⁶ See Securities Exchange Act Release No. 78101 (June 17, 2016), 81 FR 41142, 41157 (June 23, 2016) (In the Matter of the Application of Investors' Exchange, LLC for Registration as a National Securities Exchange; Findings, Opinion, and Order of the Commission).

resting prices, which, because they are only one MPV less aggressive, still will be eligible to trade against incoming orders that are aggressively seeking liquidity slightly through the best displayed price. At the same time, their protection from algorithms that may be seeking to trade at a potentially soon-to-be stale price will be enhanced.

To the extent this enhancement incentivizes the entry of additional Discretionary Peg orders on the Exchange by better protecting them from adverse selection, it could increase overall liquidity available on the Exchange to the benefit of all market participants and provide additional opportunities for price improvement to market participants removing liquidity on the Exchange during periods of quote stability.

The Commission agrees with the commenter that the impact on displayed liquidity is an important consideration, and the Commission agrees with IEX's response that the design of the Discretionary Peg order achieves a reasonable balance in that regard. Specifically, because Discretionary Peg orders exercise the least amount of price discretion, they may trade at prices more aggressive than resting displayed orders only when the active order is priced less aggressive than the NBBO (i.e., active sell orders priced higher than the NBB or active buy orders priced lower than the NBO). As such, Discretionary Peg orders are not "jumping over" resting displayed interest on IEX because those types of incoming orders are priced such that they are not marketable against the displayed orders.

Finally, the Commission believes that the conforming changes to the description of the resting price of Discretionary Peg orders for purposes of ranking and priority in the Regular Market Session Opening Process for Non-IEX-Listed Securities is consistent with the protection of investors and the public interest because as it conforms those provisions to the change being made to the resting price of Discretionary Peg orders, which change the Commission addresses above.

Accordingly, the Commission finds that this proposed rule change, as modified by Amendment No. 1, is designed 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.

V. Solicitation of Comments on Amendment No. 1

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether Amendment No. 1 is consistent with the Act. 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 email to rule-comments@sec.gov. Please include File Number SR-IEX-2018-23 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 Number SR-IEX-2018-23. This file number should be included in the subject line if email 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 Section, 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 will also be available for inspection and copying at the IEX's principal office and on its Internet website at www.iextrading.com. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-IEX-2018-23 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1

The Commission finds good cause to approve the proposed rule change, as modified by Amendment No. 1, prior to the 30th day after the date of publication of the notice of Amendment No. 1 in the Federal Register. As noted above, in Amendment No. 1, the Exchange specified that, if the Commission were to approve its proposed rule change, the Exchange would implement it within ninety (90) days of Commission approval and would provide market participants with at least 10 days of notice via a Trading Alert once a specific implementation date is determined. Because Amendment No. 1 relates to the implementation of the proposed rule change and does not make any substantive changes to the proposal, the Commission believes that good cause exists for accelerated approval of the proposed rule change, as modified by Amendment No. 1. The Commission further notes that the original proposal was subject to a 21 day comment period; and three comments were received, and considered, on the proposal.

Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,³⁷ to approve the proposed rule change prior to the 30th day after the date of publication of the notice of Amendment No. 1 in the Federal Register.

VII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁸ that the proposed rule change (SR-IEX-2018-23), as modified by Amendment No. 1, hereby is approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁹

Eduardo A. Aleman,
Deputy Secretary.

³⁷ 15 U.S.C. 78s(b)(2).

³⁸ 15 U.S.C. 78s(b)(2).

³⁹ 17 CFR 200.30-3(a)(12).

