citi

August 22, 2012

Via Electronic Mail (rule-comments@sec.gov)

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File No. SR-NASDAQ-2012-090; Notice of Filing of Proposed Rule Change to Amend Nasdaq Rule 4626 – Limitation of Liability

Dear Ms. Murphy:

Citigroup Global Markets Inc. ("CGMI") and its affiliate Automated Trading Desk Financial Services, LLC ("ATD" and, together with CGMI, "Citi")[1] appreciate the opportunity to comment on the above-referenced filing, which is a proposed rule change filed by The Nasdaq Stock Market, LLC (collectively with NASDAQ OMX Group, Inc., "Nasdaq") with the U.S. Securities and Exchange Commission (the "Commission") on July 26, 2012 (the "SEC Submission"). Citi also participated in the preparation of a separate comment letter on the SEC Submission submitted by the Securities Industry Financial Markets Association ("SIFMA"), dated as of the date hereof (the "SIFMA Letter"). We generally support the analysis and views set forth in the SIFMA Letter, but are writing separately to highlight additional comments with regard to the issues described below.

---

[1] Citigroup Inc. is a diversified global financial services holding company whose businesses provide a broad range of financial services to consumer and corporate clients as well as governments and other institutions. Citi has some 200 million client accounts and does business in more than 100 countries. Citi's primary U.S. broker-dealer subsidiary, Citigroup Global Markets Inc., is registered as a broker-dealer in all 50 states, the District of Columbia, Puerto Rico, Taiwan and Guam, and is also a primary dealer in U.S. Treasury securities and a member of the principal United States futures exchanges. Other Citi affiliates actively engaged in U.S. equity market trading include Automated Trading Desk Financial Services, LLC (ATD) and LavaFlow, Inc. Additional information may be found at www.citigroup.com or www.citi.com.

I. INTRODUCTION

Nasdaq proposes to modify its Rule 4626 in an effort to compensate Nasdaq market participants for a small portion of the losses they suffered (in the case of Citi, only a very small fraction of its total losses) as a result of Nasdaq's mishandling of the initial public offering ("IPO") of Facebook, Inc. ("Facebook") on May 18, 2012. Citi respectfully submits that Nasdaq's proposal is premised on several flawed assumptions.[2]

First, Citi believes that Nasdaq's proposal is insufficient for a number of fact-based reasons enumerated below. Nasdaq was grossly negligent in its handling of the Facebook IPO, and as such, Citi should be entitled to recover all of its losses attributable to Nasdaq's gross negligence, not just a very small fraction as is currently the case under the proposed SEC Submission. At a minimum, Citi believes that the appropriate level of compensation should be measured using a volume weighted average price (VWAP) calculation for shares of Facebook between (a) the opening price on Monday, May 21, and (b) 12:00PM on Monday, May 21 (Nasdaq's deadline for submitting accommodation requests to them). The justification for this VWAP measurement is that, while Nasdaq purports to believe all member firms should have known their positions at exactly 1:50PM on Friday, May 18 (when Nasdaq first began sending back to its customers execution reports for the IPO Cross that occurred at 11:30AM), the reality is that the vast majority of Nasdaq's customer base did not know their true position until well after the close of business on Friday, May 18.[3] In fact, Nasdaq knew full well that this was the case as it attempted to run an *ad hoc* "post-close cross" (and distributed public "Market System Status Messages" to this effect) in an apparent attempt to help its members reduce their positions, a cross which ultimately resulted in no shares actually executing. Thus, Nasdaq knew that the majority of its customers were forced to carry significant positions over the weekend, and that they were not able to close those positions until trading began on Monday, May 21.[4]

Second, Citi believes that Nasdaq's contention that Nasdaq is immune from liability for mishandling the Facebook IPO because it was acting in a regulatory capacity[5] is incorrect and unsupported by legal precedent. The law is clear that Nasdaq does not

---

[2] By filing this comment to the SEC Submission, Citi does not intend to waive its right to seek relief from Nasdaq through appropriate legal channels and expressly reserves all of its rights with respect thereto.

[3] In fact, it took most member firms weeks – not days – to fully know their true positions in the stock.

[4] Citi also takes issue with Nasdaq's requirement that all customers had to submit their claims by 12:00PM on Monday, May 21. Nasdaq knew many of its customers held very large positions as a result of Nasdaq's issue opening the stock on Friday, May 18, and by forcing customers to submit claims for loss by 12:00PM on Monday, May 21, member firms were forced to put undue stress on Facebook stock. This contributed to the further decline of the stock price under the weight of heavy sell volume from those stuck in positions after Nasdaq's issues at the open on Friday, May 18.

[5] *See, e.g.*, SEC Submission at 2 (Nasdaq enjoys "common law immunity"), 4 (Nasdaq exercised "regulatory judgment").

enjoy immunity from liability for its misdeeds where it was acting in its capacity as a profit-maximizing, publicly-held corporation. The era of market self-regulation has passed. Nasdaq no longer regulates its market participants; they are regulated by FINRA. Nasdaq's rule book is not posted on the home page of its website. The vast majority of its market related rules have been deleted. Nasdaq's regulatory focus has been narrowed to the operation of its listing and stock trading businesses, a clear conflict of interest. Moreover, most of the existing case law on the immunity issue involves exchange oversight of its issuers and membership, as opposed to a situation in which the exchanges' pecuniary interests were at risk. As set forth in detail below, the hundreds of millions of dollars of losses suffered by market participants in connection with the Facebook IPO resulted from a series of hasty, self-interested and high-risk ***business*** decisions by Nasdaq, which did not take full account of the negative downstream effects of those decisions.

Specifically, Nasdaq: (i) recently expanded the pre-opening order window (which had always been fifteen minutes) to four hours, and continued to accept cancels and modifications to orders up to one second before the opening cross – a known design flaw that resulted in a similar technology issue dating back to Fall 2011; (ii) subjected its systems to limited redundancy testing and had insufficient failover procedures, despite widespread anticipation of astronomical trading volume, in an effort to ensure that the hotly anticipated IPO would launch on schedule; (iii) sought to protect its reputation by failing to disclose known system limitations prior to the IPO and system failures during the morning of the IPO; (iv) encouraged continued submission of pre-market orders through 11:30AM on the morning of the IPO, notwithstanding a breakdown of its IPO cross system; (v) gave false assurances that pre-market trade orders were being processed in real time when, in reality, they were being canceled or processed hours later; (vi) made the high-risk, *ad hoc* decision to resort to an untested backup system and inferior failover procedures on the morning of the IPO in an effort to avoid the embarrassment of delaying or interrupting the IPO; and (vii) directed Citi and the entire market maker community to make their clients whole, with assurances that they would be reimbursed for client accommodations that were made at Nasdaq's direction.

Nothing about these profit-driven actions reflects a concern for the integrity of the market or otherwise suggests that Nasdaq was acting in a regulatory capacity. Indeed, before Nasdaq characterized its conduct as regulatory, and not commercial, in the SEC Submission, Nasdaq's CEO admitted in no uncertain terms that Nasdaq "did not have enough ***business judgment*** in the process."[6]

Allowing Nasdaq to avoid or limit its liability by hiding behind a regulatory shield in cases like this would contravene public policy. Crediting Nasdaq's groundless assertion of immunity would, among other things: (i) encourage Nasdaq to continue to

[6] Scott Thurm, *Nasdaq: "Arrogance" Contributed to Facebook IPO Flaws*, WALL STREET JOURNAL, June 25, 2012 (emphasis added).

make high-risk business decisions without regard for the integrity of the market and without fear of adverse consequences; (ii) cement an unfair competitive advantage for Nasdaq over broker-dealers and other market participants, whose business decisions are subject to liability; and (iii) impair confidence in the integrity of the market by signaling that market participants will not be made whole in situations like this, even if their losses are caused by Nasdaq's reckless and grossly negligent behavior.

Third, Nasdaq's foundational assumption that the losses suffered by market participants fall within the purview of Rule 4626 is inconsistent with the facts. Market participants' losses resulted not from the type of ordinary system failures contemplated by Rule 4626 (*i.e.*, its systems' failure to correctly process acknowledged orders), but rather from a known design flaw that resulted in a similar technology issue dating back to Fall 2011, as well as Nasdaq's high-risk, profit-oriented behavior prior to and during the IPO which had the effect of obscuring participant's market position and otherwise disrupting information flow in Facebook shares.

In short, having publicly acknowledged its liability for mishandling the Facebook IPO and causing "***objective, discernible harm***" to market participants (*see* SEC Submission at 2 (emphasis added)), Nasdaq should not be permitted to shield itself from liability by claiming regulatory immunity or to use Rule 4626 to compensate affected market participants like Citi for only a very small fraction of their losses.

Therefore, Citi respectfully requests that the Commission disapprove the SEC Submission, and further reject any claim that Nasdaq has regulatory immunity in this case.

II. BACKGROUND

A. Nasdaq

Nasdaq is a publicly-held Delaware corporation that operates The NASDAQ Stock Market, which is home to approximately 3,400 listed companies worth roughly $6 trillion in market capitalization. Nasdaq routinely touts itself as the "inventor of the electronic exchange," and boasts of its trading platform:

> Able to process more than 1 million messages per second at sub-40 microsecond speeds with 99.999% uptime, our technology drives more than 70 marketplaces in 50 developed and emerging countries into the future, powering 1 in 10 of the world's securities transactions.[7]

[7] *See* http://www.nasdaqomx.com/aboutus/.

In recent years, Nasdaq's strong focus has been on its activities as a publicly-held, for-profit business. In 2000, at the height of its popularity as an exchange, Nasdaq became a publicly held corporation through an IPO on its own exchange, and "changed its focus from performing regulatory functions for the government to performing as a private corporation for its own financial benefit."[8] In 2011, Nasdaq's revenue totaled $3,319,000,000.[9] As of December 31, 2011, Nasdaq had $14,091,000,000 in total assets.[10]

B. Nasdaq's Campaign To Secure The Coveted Facebook IPO

As noted by the U.S. Department of Justice, "NYSE and NASDAQ compete aggressively for listing customers as they are effectively the only companies providing corporate stock listing services in the United States."[11] Competition between the two exchanges reached new heights in connection with the Facebook IPO, which was anticipated to be the biggest technology IPO in history. They battled not only for significant listing fees and a boost in trading, but also for the chance to link their brand to the largest social networking site in the world. The stakes were even higher for Nasdaq, which views itself as the go-to exchange for computer and internet companies, following offerings by Google Inc., Apple Inc., Microsoft Corp. and Intel Corp. Thus, by the time Facebook filed its February 1, 2012 Registration Statement, Nasdaq and NYSE had been embroiled in a prolonged battle to secure the listing. As set forth below, Nasdaq devoted more energy to campaigning for the prized Facebook listing than to ensuring a smooth execution of the offering.

In early April 2012, news reports revealed that Nasdaq had secured the prized Facebook listing. Nasdaq may have prevailed over NYSE by "shortening the so-called seasoning period before new companies are admitted to the Nasdaq-100 to three months from at least one year."[12] Facebook executives likely saw in the shortened "seasoning" period the opportunity for significant additional systematic demand for its stock.

III. THE NASDAQ PROPOSAL IS INSUFFICENT

The Nasdaq's proposal to modify Rule 4626 is insufficient and should be rejected by the Commission. As evidenced by Nasdaq's initial announcement in May that it

---

[8] Craig J. Springer, *Weissman v. NASD: Piercing the Veil of Absolute Immunity of an SRO Under The Securities Exchange Act of 1934*, 33 DEL. J. CORP. L. 451, 465 (2008).

[9] *See* http://www.nasdaq.com/symbol/ndaq/financials.

[10] *See* http://ir.nasdaqomx.com/releasedetail.cfm?ReleaseID=695070.

[11] Press Release, Department of Justice, NASDAQ OMX Group Inc. and IntercontinentalExchange Inc. Abandon Their Proposed Acquisitions of NYSE Euronext After Justice Department Threatens Lawsuit (May 16, 2011), *available at* http://www.justice.gov/opa/pr/2011/May/11-at-622.html.

[12] Nina Mehta & Lu Wang, *Facebook Index Early Entry Said Talking Point With Nasdaq*, BLOOMBERG, April 25, 2012.

would set up a pool of $40 million to compensate the market for its handling of the Facebook IPO – in which Nasdaq benignly offered to contribute only $2 million in out of pocket cash – Nasdaq's only interest in accommodation was to satisfy the public perception that it failures will not result in investor losses. While the $62 million pool in this SEC Submission is a larger cash contribution, that is perhaps sufficient to mislead the investing public to believe that Nasdaq is standing up for its obligations; however, compensation paid by market maker and broker participants to their customers far exceeds the sum Nasdaq has proffered by a multiple of roughly seven. Nasdaq's proposal simply fails to take into account the confusion its known design flaw, insufficient failover procedures and reckless business judgment had on the market participants that trade there. As a result of Nasdaq's inability to confirm executions or order cancellations in a manner and in a time that provides equal information to all participants, market makers were forced to operate their businesses in the dark. Unlike Nasdaq – which actually profited from its understanding of its current position in Facebook shares – market makers who had not received information from Nasdaq regarding the status of customer orders could not make informed decisions and suffered substantial losses.

A. Nasdaq's Inadequate Preparations For The IPO

In an effort to hide behind the imprimatur of the immunity granted through the Commission, Nasdaq discusses at length in the SEC Submission the Commission's approval of the manner in which the cross system was supposed to work. However, Nasdaq's submission is ***silent*** with respect to a known design flaw and insufficient failover process. Even if the Cross had been working properly, what Nasdaq fails to mention is that it had no valid backup system. In theory, the IPO cross is meant "to provide a smooth transition for orders from the Cross to continuous trading." *Id.* at 7. In practice, the opposite occurred, and Nasdaq simply chose to roll the dice.

At the conclusion of the four-hour pre-market order period, Nasdaq claims that it "attempted to conclude the quoting period, execute the Cross and print the opening trade to the tape" (SEC Submission at 9). However, this process was repeatedly delayed, Nasdaq claims, because it "continued to receive new order, cancel, and replace messages [that] were added to the Cross order book." This is because Nasdaq agreed to accept cancels and modifications to orders up to one second before the opening cross – a known design flaw that resulted in a similar technology issue dating back to Fall 2011.

Nasdaq should have halted the IPO when the Crossing system continued to accept new market information rather than determine a Crossing price; instead Nasdaq took conflicting action. Even though the system continued to receive information and force continuous updates of the opening Cross price, Nasdaq determined and even encouraged participants to add and update orders, thus adding new pricing information for the system to digest at a time when it was having difficulty with the information received as of 11:05AM. In a hasty, high-risk move, Nasdaq unilaterally gambled that its systems would function properly, despite the issues that it was beginning to experience at the time. The fact is that, in the twenty minutes between 11:11-11:30:10AM, approximately seven million shares were not included in the opening cross.

B. The Exercise of Business Judgment Yields Chaotic Trading Activity

Nasdaq claims in the SEC Submission that once trading commenced, "price discovery was occurring in an orderly fashion in the continuous market." Further, NASDAQ claims that "investors should have somehow divined the execution or non-execution of their orders despite the lack of trade confirmations", and that "active, deep, and liquid trading was taking place in FB stock on Nasdaq . . . ." (SEC Submission at 11). Nasdaq likewise claimed that its "systems operated normally in handling all of the FB orders entered and executed after the Cross." *Id.* These statements are patently misleading. In reality, Nasdaq experienced abundant problems throughout the day, and Nasdaq's problems directly caused significant market-wide problems. Nasdaq proposes the Commission adopt its rule because its conduct was regulatory in nature and in the interest of maintaining an orderly market. *However, Nasdaq sees the geography of the market ending at its front door and is unwilling to see beyond that door to the chaotic market conditions it caused.* Nasdaq's problems most of which had serious downstream affect included, *inter alia*, the following:

- "In the period between 11:30 a.m. and 1:50 p.m. . . . system issues prevented Nasdaq from disseminating Cross transaction reports" (SEC Submission at 4). Thus, legions of investors were unable to make rational trading decisions because they had no idea whether they owned Facebook stock or not.[13] In some cases, investors submitted multiple redundant orders based on the belief that the orders were not going through. In other cases, investors submitted cancelations before receiving order confirmations, but were stuck with the stock.

- Furthermore, those investors who had ultimately purchased Facebook stock in the opening cross were prevented from selling their positions as the stock moved lower, because the execution reports had not come back immediately and the positions were not in their accounts. As a result, any such sales would have had to be short sales – which is difficult/impossible during an IPO because there may not be any shares to locate.

- Huge numbers of orders, modifications and cancelations, which are typically processed in an instant, took hours to execute. This resulted in many investors receiving inferior prices long after they had placed orders.

[13] In the SEC Submission, Nasdaq claims that investors should have somehow divined the execution or non-execution of their orders despite the lack of trade confirmations. *See* SEC Submission at 12 ("In spite of the absence of confirmation messages, Nasdaq believes that market participants – based on all of the information available at the time, their experience with Nasdaq crosses, and established trading priorities – would reasonably have had certain expectations for the execution or non-execution of their orders."). This is untenable.

- For the first two hours and twenty minutes of trading (until 1:50PM), Nasdaq failed to publish an eligible National Best Bid/Offer ("NBBO"), which represents the best price available on any market at the time an order is placed. During the time when Nasdaq had no published NBBO quotation, roughly 272 million shares of Facebook were traded without any assurance that investors were receiving fair and equitable prices.

- During that same period, Nasdaq's bid price was stuck at $42.99, even though quotes from other exchanges were moving. Likewise, for nearly two hours, Nasdaq's ask price was frozen at $38.01. An order book with buy orders higher than sell orders is a market anomaly that should not have been allowed to exist at the opening of trading, and certainly should not have been allowed to persist, as it did here, for hours.

In short, Nasdaq's reckless, profit-oriented decision to open trading despite system malfunctions, insufficient failover procedures and a known design flaw resulted in rampant confusion and further system failures, not, as Nasdaq claims, "active, deep, and liquid trading."

Furthermore, while market participants were hemorrhaging money, Nasdaq made $10.8 million from trading out of a position in Facebook shares that it had taken during the commotion on May 18.[14] Nasdaq's explanation is that "[c]ancellations received [between 11:11:00 and 11:30:09 AM] were processed in real time, resulting in Nasdaq assuming in its error account the cancelled buy and sell positions. Notably here is the fact that Nasdaq market makers were unable to do what Nasdaq had done. Market makers could not see their positions in real time, nor could their customers. Accordingly while Nasdaq resolved its trading gains, other market participants, namely Nasdaq market makers, their customers and investors, observed price changes in Facebook shares but could only hope that their attempts at submitting contra and cancellation orders would defray exposure arising out of their lack of information. Nasdaq's net error account position was a short position of 3,070,430 shares" (SEC Submission at 11 n.19). Thereafter, Nasdaq admits, it purchased the shares in the open market for a $10.8 million gain. Ultimately, under pressure from the investing public and the Commission, Nasdaq has agreed to disgorge the $10.8 million profit (as part of, and not in addition to, the $62 million it proposes to use for voluntary accommodations).

Nasdaq had help but chose to ignore it. Market makers – and in particular, the four largest wholesale retail market makers, of which Citi (through its affiliate ATD) is one – play an essential role in the trading process, especially at the market open and especially on the day of an IPO. Each of the four largest market makers communicated to

---

[14] *See* Jacob Bunge, *UPDATE: Nasdaq Confronts Liability on Traders' Losses in Facebook IPO*, WALL STREET JOURNAL, May 21, 2012.

Nasdaq that there were problems on the morning of the Facebook IPO and recommended that Nasdaq halt the stock until such issues could be resolved in a transparent manner. Nonetheless, Nasdaq refused, as doing so undoubtedly would have caused great embarrassment for Nasdaq.

Nasdaq's grossly negligent conduct in opening trading despite that the cross "***experienced unexpected and unprecedented difficulties***" (SEC Submission at 15), is further highlighted by the fact that it kept officials and market participants in the dark. The communications line Nasdaq had opened to keep market participants informed remained completely silent *for nearly twenty minutes*. Nasdaq's failure to notify market makers like Citi of what was going on behind the scenes is inexcusable. Had Nasdaq disclosed the alarming technical problems that were ravaging its system, market makers like Citi would have been able to alert their customers and take appropriate action. Transparency is a crucial element in maintaining a fair and orderly market.

There was precedent for making a more cautious, rational decision. Just two months prior, another major stock exchange experienced technology issues on the day of its own IPO. BATS was the listing exchange of its own IPO; while not as large as the Facebook IPO in terms of number of orders, one could easily argue that BATS' listing of its own IPO was at least as significant an event for them as the Facebook IPO was for Nasdaq. Despite significant embarrassment over the technology issues it experienced on the day of its own IPO, BATS made the responsible decision not to open the stock, and in fact cancelled/postponed its own IPO, rather than compromise the integrity of the markets. Nasdaq's failure to do so, especially given the recent BATS precedent and the cautions of the four largest market makers, evidences a significant lack of business prudence and market integrity that rises to the level of gross negligence.

Nasdaq believed that it had evaded a business crisis by switching systems – without having to publicize its system failures. However, the result of its *ad hoc* solution was harm to market makers, investors and the market. Nasdaq could have cancelled the opening session, cancelled existing orders and carefully evaluated the system issues before proceeding with the IPO. Understanding that cancelling an IPO would cause significant, negative harm to their listing business, Nasdaq determined to proceed rather than cancel and investigate. The right regulatory action in face of serious uncertainty should have been to step back and carefully assess the situation. Instead Nasdaq chose to switch servers on the fly and embark on an unproven failover process, hence making a hasty impetuous decision unbecoming of a regulator concerned with the integrity of its market.

Later during the day of the IPO, Citi had called Nasdaq several times in an attempt to obtain information. After the market closed on May 18, 2012, Citi spoke with Nasdaq officials. Citi explained that its losses were in the millions and were still mounting. In response, Nasdaq instructed Citi to compensate its customers for losses they sustained during the chaotic IPO and led Citi to reasonably believe that its losses would be reimbursed later.

Citi complied with Nasdaq's directive and made its customers whole. As a result, it incurred substantial losses far greater than the amount it would receive under the SEC Submission. Given that Citi complied with Nasdaq's instructions – helping to mitigate the damage to Nasdaq's reputation by compensating investors – Nasdaq's current offer of a fractional reimbursement is indefensible.

Nasdaq has plainly admitted its fault in connection with the Facebook IPO. In the SEC Submission, Nasdaq acknowledged that it commenced the offering and allowed trading to continue despite experiencing "***unprecedented difficulties***" with its systems, and that its actions "***caused objective, discernible harm***" market participants (SEC Submission at 2, 15 (emphasis added)).

Nasdaq has made similar statements to the press. Nasdaq's CEO has admitted to being "humbly embarrassed" by Nasdaq's failure and acknowledged that the Facebook IPO was not the company's "finest hour."[15] He has even admitted that "arrogance" and "overconfidence" among Nasdaq personnel contributed to the exchange's lack of preparedness for the enormous trading volume.

Through Nasdaq's own admissions, it seems clear that culpability exists; at this point it seems the only open issue is the appropriate level of compensation owed to market makers like Citi, who stepped into the void that Nasdaq's trading issues created on the day of the Facebook IPO. At a minimum, Citi believes that the appropriate level of compensation should be measured using a volume weighted average price (VWAP) calculation for shares of Facebook between (a) the opening price on Monday, May 21, and (b) 12:00PM on Monday, May 21 (Nasdaq's deadline for submitting accommodation requests to them). The justification for this VWAP measurement is that, while Nasdaq purports to believe all member firms should have known their positions at exactly 1:50PM on Friday, May 18 (when Nasdaq first began sending back to its customers execution reports for the IPO Cross that occurred at 11:30AM), the reality is that the vast majority of Nasdaq's customer base did not know their true position until well after the close of business on Friday, May 18.[16] In fact, Nasdaq knew full well that this was the case as it attempted to run an *ad hoc* "post-close cross" (and distributed public "Market System Status Messages" to this effect) in an apparent attempt to help its members reduce their positions, a cross which ultimately resulted in no shares actually executing. Thus, Nasdaq knew that the majority of its customers were forced to carry significant positions over the weekend, and that they were not able to close those positions until trading began on Monday, May 21.

---

[15] Jenny Strasburg & Jacob Bunge, *Nasdaq Is "Humbly Embarrassed" Over Facebook Troubles*, WALL STREET JOURNAL, May 20, 2012.

[16] In fact, it took most member firms weeks – not days – to fully know their true positions in the stock.

IV. NASDAQ SHOULD NOT ENJOY IMMUNITY IN THIS CASE

A. Public Policy Disfavors Allowing Nasdaq To Cloak Its Actions In Immunity

Despite Nasdaq's acknowledgement of the harm caused by its system issues, Nasdaq's position is that the accommodation payments specified in the proposed amendments to Rule 4626 would adequately compensate member firms and best serve the public interest (SEC Submission at 27). However, Nasdaq's proposal raises significant public policy concerns. From a policy standpoint, Citi believes that allowing Nasdaq to limit its liability – either by claiming regulatory immunity or hiding behind a rule-based cap on its liability – would be detrimental to the public interest and the integrity of the market.

First, Nasdaq admits that its proposal that its "system difficulties caused objective, discernible harm" (SEC Submission at 2). If Nasdaq is under no threat of liability as a result of its actions that led to this harm, Nasdaq has little or no incentive to behave differently in the future. Nasdaq was aware that the Facebook IPO was anticipated to be the largest technology IPO in history and made efforts to beat out NYSE for the opportunity to list Facebook. But, even with the world watching and significant financial and reputational incentives to Nasdaq, it made a series of risky business decisions in the days leading up to and during the IPO. Immunity in this case would only encourage Nasdaq to continue to make high-risk business decisions without regard for the integrity of the market. The best way to ensure future technology and similar problems do not occur is to reject Nasdaq's claim of immunity from liability.

Second, if Nasdaq's actions with respect to the Facebook IPO are cloaked in regulatory immunity, Nasdaq would have an improper competitive advantage over other market participants. The limitations on Nasdaq's liability were instituted when it was owned by its member firms in order to ensure that one member owner did not have to shoulder the burden of technology-related losses of its competitor. Today, that basis for a limitation on liability is inapplicable, as Nasdaq is a publicly-traded corporation with billions of dollars in annual revenue and hundreds of millions of dollars in annual profit. Nasdaq derives a large portion of its profits from listing stocks and facilitating trading. If Nasdaq is immune from liability in connection with these activities by asserting a regulatory shield, it will have a clear unfair competitive advantage.

Market structure developments have brought about some degree of competition between market centers that are operated by brokers and those market centers that are exchanges (see, e.g., the Commission's recent approval of the New York Stock Exchange's Retail Liquidity Program, granting the ability of the NYSE to compete for retail order flow by quoting in subpenny increments – other exchanges such as Nasdaq have or are expected in the near future to file for similar privileges). A significant remaining difference, nonetheless, is that the liability of brokers is limited only by their ability to negotiate limiting contracts with clients, whereas for-profit exchanges enjoy full immunity. Brokers have no statutory or rules-based limitation on the dollar value of their errors. Nasdaq effectively takes the position that it should not have liability for its failings because the for-profit exchanges are too critically important to have to potentially stand up for their errors, while brokers who fail as a result of poor planning must pay for their failure. This is an unlevel playing field premised on an outdated construct of exchanges as bastions of market integrity, rather than the for-profit corporations that they are today.

Third, Nasdaq's attempt to cloak its actions as an exercise of regulatory authority would extend an overly broad level of immunity to a for-profit corporate entity that is reserved for government and governmental actors. The SEC should be wary of extending an excessive level of immunity to for-profit corporate entities that lack the democratic accountability that legitimizes our federal and state governments. Nasdaq will not be left without defense; it has and will continue to have any protections afforded by contractual liability limitations.

Nasdaq addressed these public policy concerns in its proposal by stating that the public interest is served by making only the limited accommodation payments they suggest; otherwise, "the potential would exist for a single catastrophic event to bankrupt one or multiple exchanges" (SEC Submission at 27). However, errors committed by Nasdaq in connection with the Facebook IPO were not of the routine nature Rule 4626 was intended to accommodate; they were a product of a known design flaw, system failures brought on by a lack of preparedness and grossly negligent conduct, and wanton disregard for the public interest. *Put simply, is it acceptable for Nasdaq to argue immunity when its same actions could potentially bankrupt one of its customers?*

Nasdaq had months to prepare adequately for the Facebook IPO and failed to do so. The for-profit nature of Nasdaq weighs against treating it like a governmental actor and eliminating the risks of its failed business decisions, especially where it has acted in a grossly negligent manner. Rather, the public and the markets will be better served if Nasdaq has the threat of liability and thus the incentive to take steps to avoid any single catastrophic event. Making market participants whole, especially under the circumstances present in the Facebook IPO, will only serve to enhance the confidence in and integrity of the market by demonstrating that it is a level playing field.

B. The Commission Should Not Endorse, and Nasdaq Is Not Entitled To Immunity Because It Was Acting As A For-Profit Corporation, Not As A Regulator

Nasdaq claims in the SEC Submission, with no basis in fact or law, that it enjoys "common law immunity."[17] However, Nasdaq cannot cloak its actions in immunity because it was acting exclusively as a for-profit business, and not as a market regulator, when it made the grossly negligent business decisions that caused market participants

---

[17] SEC Submission at 2.

hundreds of millions of dollars of losses. We urge the Commission not in any way to endorse the proposition that Nasdaq's handling of the Facebook events were regulatory in nature thus immunizing Nasdaq from liability.

It is true that Nasdaq enjoys immunity from liability for exercising statutorily-delegated regulatory functions.[18] However, the law is clear that when conducting private business, it remains subject to liability.[19] As explained by the Eleventh Circuit, Nasdaq is not entitled to immunity when it is engaging in "non-governmental activities that serve its private business interests, ***such as its efforts to avoid a failed IPO, and/or increase trading volume and company profit*** . . . ."[20] Furthermore, the Second Circuit has "cautioned that the doctrine [of immunity for SROs] is of a rare and exceptional character, . . . [and the] party asserting immunity bears the burden of demonstrating its entitlement."[21]

Against this backdrop, Nasdaq simply has no valid claim to immunity. It was acting exclusively to further its business objectives as a for-profit corporation when it: (i) recently expanded the pre-opening order window (which had always been fifteen minutes) to four hours, and continued to accept cancels and modifications to orders up to one second before the opening cross – a known design flaw that resulted in a similar technology issue dating back to Fall 2011; (ii) subjected its systems to limited redundancy testing and had insufficient failover procedures, despite widespread anticipation of astronomical trading volume, in an effort to ensure that the hotly anticipated IPO would launch on schedule; (iii) sought to protect its reputation by failing to disclose known system limitations prior to the IPO and system failures during the morning of the IPO; (iv) encouraged continued submission of pre-market orders through 11:30 AM on the morning of the IPO, notwithstanding a breakdown of its IPO cross system; (v) gave false assurances that pre-market trade orders were being processed in real time when, in reality, they were being canceled or processed hours later; (vi) made the high-risk, *ad hoc* decision to resort to an untested backup system and inferior failover procedures on the morning of the IPO in an effort to avoid the embarrassment of delaying or interrupting the IPO; and (vii) directed Citi and the entire market maker community to make their clients whole, with assurances that they would be reimbursed for client accommodations that were made at Nasdaq's direction.

---

[18] *See Std. Inv. Chartered, Inc. v. NASD*, 637 F.3d 112, 115 (2d Cir. 2011).

[19] *See Weissman v. NASD*, 500 F.3d 1293, 1294 (11th Cir. 2007) (Nasdaq "is not entitled to immunity [where a] complaint relates to private commercial conduct not delegated by the Act.").

[20] *Weissman*, 500 F.3d at 1297 (emphasis added); *see also Opulent Fund, L.P. v. NASDAQ Stock Mkt., Inc.*, No. 07-CV-3683, 2007 WL 3010573, at *4-5 (N.D. Cal. Oct. 12, 2007) (pricing an index was not regulatory in nature and immunity was unavailable where Nasdaq profited from the activity and was not acting to protect investors but to create a market and increase trading).

[21] *Std. Inv. Chartered*, 637 F.3d at 115-16 (internal citations omitted).

Although Nasdaq readily acknowledges that "[t]he Cross process in FB did not operate as expected" (*see* SEC Submission at 9), its explanation for the delays and system breakdowns is misleading and incomplete. Even putting aside the issue of why Nasdaq would design a system without adequate failover processes, to make matters worse, Nasdaq falsely represented to market makers such as Citi that it was processing orders in real time. In reality, orders were being canceled or processed hours later. Such blatant misrepresentations are certainly not regulatory in nature. The markets expect regulators to act in an objective, transparent fashion so that market intelligence is added and confidence is not adversely affected. Nasdaq determined to take the opposite, profit-oriented course. Indeed, Nasdaq has admitted that these representations were untrue:

> "As a result of the systems difficulties . . . , certain orders for FB stock that were entered between 11:11:00 a.m. in the expectation of participating in the Cross – and that were not cancelled prior to 11:30:09 – either did not execute or executed after 1:50 p.m. at prices other than the $42.00 price established by the Cross."

There is no conceivable basis for claiming that these acts of malfeasance should be deemed the acts of a regulator undertaken to protect the integrity of the market. They were, quite simply, self-interested business decisions by Nasdaq. In fact, Nasdaq's CEO specifically has admitted that the company was acting in a business capacity: "We did not have enough ***business judgment*** in the process."[22]

According to the SEC Submission, "[u]pon concluding shortly before 11:30 a.m. that a ***system modification*** would resolve all system issues, Nasdaq, ***in an exercise of its market oversight obligations***, determined to proceed with the IPO" (SEC Submission at 10 (emphasis added)). This is misleading in at least two respects. First, Nasdaq's passing reference to a "system modification" downplays what really happened. At the end of the thirty minute delay, with pressure to launch the hotly anticipated IPO mounting, Nasdaq made a high-risk gamble to replace the malfunctioning system with a backup system – *whose capacity and ability to understand and operate with older code had not been appropriately stress-tested* – and open trading. Nasdaq CEO Bob Greifeld has since admitted that the backup system was more primitive than the primary system. During a June 6, 2012 live television interview with CNBC reporter Maria Bartiromo, he explained that, after experiencing problems setting an opening price, Nasdaq had to "revert back to a simpler code base."[23]

---

[22] Scott Thurm, *Nasdaq: "Arrogance"* (emphasis added).

[23] Press Release, CNBC, CNBC Transcript: CNBC's Maria Bartiromo Sits Down with NASDAQ OMX Group, Inc. Chief Executive Officer Robert Greifeld Today at 4PM ET (June 6, 2012).

Nasdaq's description of the decision as an exercise of "market oversight obligations" and as "an exercise of regulatory authority"[24] is both a mischaracterization and a clear attempt to lay the groundwork for its claim of regulatory immunity. Nothing about this decision was regulatory; indeed, Nasdaq makes no attempt to explain how it is regulatory (and does not explain how the issue was discovered or addressed). To the contrary, Nasdaq made a calculated, high-risk ***business decision*** to replace the malfunctioning system with an older system without appropriately testing the failover process.

V. NASDAQ RULE 4626 SHOULD NOT ACT AS A LIMIT TO NASDAQ'S LIABILITY

Citi believes that the Commission should not approve Nasdaq's proposed amendment to Rule 4626. Approval of the Rule would be a tacit acknowledgement that Nasdaq's behavior was within appropriate guidelines.

Nasdaq's assumption that it must amend Rule 4626 to in order to create a voluntary accommodation fund in connection with the Facebook IPO is fundamentally flawed because the losses suffered by market participants do not fall within the purview of Rule 4626.

Nasdaq Rule 4626(b) places limits on the extent to which Nasdaq "may compensate users of the Nasdaq Market Center for losses directly resulting from the systems' actual failure to correctly process an order, Quote/Order, message, or other data, provided the Nasdaq Market Center has acknowledged receipt of the order, Quote/Order, message or data." Nasdaq's foundational assumption that this Rule is even relevant to the Facebook IPO is untenable.

As set forth herein, market participants' losses were not caused by a system glitch; they were caused by grossly negligent, self-serving business decisions made by Nasdaq to enhance its own profitability, including: (i) recently expanding the pre-opening order window (which had always been fifteen minutes) to four hours, and continuing to accept cancels and modifications to orders up to one second before the opening cross – a known design flaw that resulted in a similar technology issue dating back to Fall 2011; (ii) subjecting its systems to limited redundancy testing and having insufficient failover procedures, despite widespread anticipation of astronomical trading volume, in an effort to ensure that the hotly anticipated IPO would launch on schedule; (iii) seeking to protect its reputation by failing to disclose known system limitations prior to the IPO and system failures during the morning of the IPO; (iv) encouraging continued submission of pre-market orders through 11:30AM on the morning of the IPO, notwithstanding a

---

[24] *See* SEC Submission at 3-4 ("Based on its assessment of the information available at the time, Nasdaq concluded that the system issues would not have any effects beyond the delay itself. In an exercise of regulatory authority, Nasdaq determined to proceed with the IPO at 11:30 a.m. rather than postpone it.").

breakdown of its IPO cross system; (v) giving false assurances that pre-market trade orders were being processed in real time when, in reality, they were being canceled or processed hours later; (vi) making the high-risk, *ad hoc* decision to resort to an untested backup system and inferior failover procedures on the morning of the IPO in an effort to avoid the embarrassment of delaying or interrupting the IPO; and (vii) directing Citi and the entire market maker community to make their clients whole with assurances that they would be reimbursed for client accommodations that were made at Nasdaq's direction. These actions simply were not the kind of *operational* issues contemplated by Rule 4626.

Nasdaq's attempt to hide behind a plainly inapplicable Rule should not be countenanced by the Commission.

VI. CONCLUSION

Regardless of whether compensation to member firms is made through Rule 4626 or otherwise, Citi respectfully requests that Nasdaq and the Commission address the two procedural issues highlighted in the SIFMA Letter. First, given the time it could take to implement a compensation scheme, Nasdaq should waive the one-year time limit in Section 18 of its Services Agreement in connection with any claims, disputes, controversies, or other matters in question relating to the Facebook IPO. Second, Nasdaq should be required to provide clarification that member firms participating in any voluntary accommodation plan will not be required to release Nasdaq from liability until they have received a final payment amount under such plan.

Market participants suffered hundreds of millions of dollars of losses as a result of Nasdaq's profit-driven conduct prior to and during the Facebook IPO, not as a result of (i) protected regulatory activity by Nasdaq, or (ii) routine system failures. Thus, Nasdaq should not be permitted to hide behind regulatory immunity or the damages limitation in Rule 4626. Therefore, Citi respectfully requests that the Commission disapprove the SEC Submission, and further reject any claim that Nasdaq has regulatory immunity in this case.

* * * * *

Citi appreciates the opportunity to comment on the proposed modification to Nasdaq Rule 4626. We look forward to discussing the matter further with the Commission and its staff. If you have any comments or questions, please do not hesitate to contact me at 212.723.1812 or daniel.keegan@citi.com.

Sincerely,

Daniel Keegan
Managing Director

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
Robert W. Cook, Director, Division of Trading and Markets
David Shillman, Associate Director, Division of Trading and Markets