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November 23, 2009

Elizabeth Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

**Re: File No. S7-21-09; Flash Orders**

*FROM THE BUSINESS PRESS INTERNATIONAL NEWSWIRE*

*Washington, D.C. January 3, 2011. The business lobby group Businesses Aligned to Prevent Price Improvement, or BAPPI, today announced a drive to enact the Consumer Relief Initiative for Pride and Protection Legislative Engagement Act of 2010, or "CRIPPLE." CRIPPLE would prevent any business in the United States from asking its sales force to match a better price of a competitor. Explains BAPPI leader Rod Kanehl, "Why bother asking anyone to improve their prices? The government should require people to advertise their best prices. And if they don't have the best price, they must reject a customer's order. Better yet, the government should require a business to send the customer to a competitor who has a better price." He continued that CRIPPLE is based on a late 2009 rule the U.S. Securities and Exchange Commission passed banning a securities market from "flashing orders" to meet or better competing prices. Rather, markets must reject such orders or forward them to a competing market.*

*Reacting to CRIPPLE, Ed Charles, spokesman for the consumer-oriented think-tank Selective Management for Advanced and Rational Technology, or SMART, said: "CRIPPLE is a solution in search of a problem. At least it is aptly named, as this will cripple competition rather than enhance it. It effectively ends all forms of competition other than advertised price competition. Companies compete in many ways, including service and technology. Consumers who have strong relationships with their favorite retailers may not be able to shop there any longer. CRIPPLE isn't even rational on its face, since it allows companies that advertise the best price to slap on service fees or cease offering any customer service. Companies have been competing in multiple ways for years, and the ability to match better prices never has been an impediment to price competition and engaging in sales, even when companies know that their competitors will offer to match them. We were not aware of anyone ever complaining about this until BAPPI made it a national issue. It seems that this is driven more by competitive self-interest than protecting consumers. If BAPPI sees specific problems with any of the competitive processes in the market, let them identify the problems so we can fix them. We do not need government to micro-manage healthy market competition."*

*Elliott Maddox, shopping for a new flat panel TV at Gary Kolb's TV Emporium, was perplexed when hearing about the proposed law, saying that he always shopped at Kolb's: "The salesmen here know what they are talking about and always respond quickly to problems I may have. If I find a better price somewhere else they always match it – they know I'll go elsewhere if they don't. And sometimes they even throw in a free extended warranty. Now that is service! You're telling me the government is going to force me to buy my TVs elsewhere?! Yeah, I know some places may advertise a bit less for some products, but they overcharge others to subsidize those lower prices. And from what I've heard, their 'customer service' line can be better called a 'lack of help' line. Why should I support that pricing model?" Based on these reactions to BAPPI's proposal, it would seem that CRIPPLE will be a tough sell in Congress.*

Dear Ms. Murphy:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to comment on the Commission's rule proposal (the "Proposal") regarding "flash orders."<sup>1</sup> As the fictional news release above indicates, we believe that flash orders provide benefits to the markets and that the Commission should not ban this well-accepted trading practice. Indeed, we do not understand how a practice the Commission has blessed over the years, for which the Commission can cite no actual harm, and for which there seems to be fewer issues in today's automated trading environment than on manual floor-based markets, suddenly has become an issue of such critical importance that the Commission has accelerated a proposed ban prior to addressing other market practices.<sup>2</sup> Unfortunately it seems that unfounded populist sentiment, further fueled by political and competitive jockeying, has driven much of the current flash order controversy.<sup>3</sup> This is not the proper way to formulate important regulatory policy that will shape the nation's securities industry for years to come.

Banning a practice is drastic action, which we believe the Commission should take only in extreme situations. Flash orders are not unique. There are many other practices that benefit the market but may pose certain risks. In those cases, the Commission has been able to address the risks through regulatory action, without banning the activity:

- Short sales: Recognizing the problems with abusive short selling, the Commission has regulated, rather than banned short sales.<sup>4</sup> In fact, the 2008 ban of short sales generally can be viewed in retrospect as raising more problems than benefits.
- "Triple Witch": There is a triple witch when multiple derivative products are priced on the same closing values. Although establishing these settlement values simultaneously at the market close created extreme volatility, the markets did not ban the instruments. Rather, they adjusted the timing of determining the products' settlement values.<sup>5</sup>

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<sup>1</sup> Release No. 60684 under the Securities Exchange Act of 1934 ("Exchange Act") (September 18, 2009); 74 F.R. 48631 (September 23, 2009) (the "Release").

<sup>2</sup> Release No. 34-60997 (November 13, 2009); 74 F.R. (November , 2009). 74 F.R. 61208 (November 23, 2009).

<sup>3</sup> See "The Dow Zero Insurgency," by Joe Hagan, *New York Magazine*, October 5, 2009 at 30.

<sup>4</sup> See Regulation SHO under the Exchange Act.

<sup>5</sup> See Series 2000 of the ISE's rules regarding index options.

- Insider trading: Insiders trading on proprietary information did not result in banning insiders from trading, but in regulating how and when insiders may trade.<sup>6</sup>

Despite raising significant market and investor protection issues, in none of these cases did the Commission ban the underlying activity. Rather, the Commission took targeted regulatory action to address the problems associated with these practices. We believe the Commission should treat flash orders in the same reasonable and deliberate manner. To the extent there are concerns with flash orders, we believe that properly-targeted rules could address them without compromising the benefits. We also believe that there are aspects of the options market that make the benefits of flash orders especially compelling in that market.

#### A. The Benefits of Flash Orders

On May 12, 2008 the Commission approved our rule filing establishing flash orders.<sup>7</sup> When we receive a customer order that we cannot immediately execute because there is a better price available on a competing exchange we “flash” that order for no more than one second to our entire market. If no one in our market matches – or improves – the better market away, we require our Primary Market Maker (“PMM”) to protect that customer order by seeking an execution for the order in another market through the intermarket linkage system established for that purpose. In approving flash orders the Commission stated that:

the proposal will expose public customer orders that are not executable on the [ISE] before sending a Linkage Order on behalf of the public customer. The Commission notes that exposing public customer orders before the PMM sends a Linkage Order on the public customer’s behalf will give additional ISE participants an opportunity to provide public customer orders an execution at the [national best bid or offer] (or better) on ISE and may reduce PMM costs by reducing the number of Linkage Orders sent to other exchanges. Thus, the Commission believes that the exposure rules outlined above will allow ISE to provide more efficient and competitive executions for these orders, subject to priority principles.<sup>8</sup>

In the 16 months we have offered flash orders we have not had a single customer complaint, nor a single accusation of front-running. Rather, we have a history of providing customers with faster executions, at prices sometimes better than the national best bid and offer (“NBBO”). The only complaints about flash orders have been from exchanges that view flash orders as a competitive threat. Yet the Commission now proposes to outlaw flash orders, stating its concerns that “the use of flash orders by exchanges and other markets, particularly if it were to expand in trading volume, could detract from the fairness and efficiency of the national market system.”<sup>9</sup> The Commission states that its focus is on the interests of long-term investors and whether they are helped or harmed by these orders, rather than on the interests of short-term professional traders.

It is not clear to us what so fundamentally changed in this short period of time for the Commission to view flash orders in such radically different ways. In fact, we believe that the history of flash orders shows significant benefits to the very retail customers that are the focus

<sup>6</sup> See, e.g., Rule 10b5-1 under the Exchange Act.

<sup>7</sup> File No. SR-ISE-2009-28; Release No. 34-57812 (May 12, 2008), 73 F.R. 28846 (May 19, 2008) (“Approval Order”).

<sup>8</sup> Id at 28847.

<sup>9</sup> Release at note 43.

of the Commission's attention. Indeed, in options the responders to flash orders are the market makers that provide liquidity day in and day out, not short-term professional traders. While we address the Commission's stated concerns regarding flash orders in the next section of this letter, we first believe it is critical to highlight the important benefits of this order type.

As the Approval Order indicates, the key benefit of these orders is to help investors find sources of undisplayed liquidity to fill their orders. Flash orders have their roots on the floors of exchanges where brokers announce their orders to the crowd, effectively instituting an auction to buy or sell at the best price available. That price would equal or better the exchange's posted price. There are legitimate reasons why market participants may not post their best prices in the absence of an incoming order. The primary reason is that in fast-moving markets a liquidity provider may be concerned that an opportunistic trader with some form of informational advantage may "pick off" a posted quote.

To address pick-off concerns, the liquidity provider will wait for a member to announce an incoming order, and then respond to the announcement with an offer of liquidity at or better than the prevailing exchange price. The resulting auction not only taps additional liquidity at the NBBO, but can actually provide customers with executions superior to the NBBO. This enhanced liquidity and price improvement specifically benefits public, long-term customers whose orders are exposed to the auction. Banning flash orders will lessen the liquidity available to these long-term investors and decrease their opportunities for price improvement. This is particularly important in options, where, as discussed below, market makers provide almost all the liquidity and are best positioned to respond to flash orders.

Flash orders benefit public customers in other ways as well. Of most importance, it can provide customers with price improvement over the NBBO. We analyzed all flash orders on the ISE from August 31, 2009 to October 27, 2009. The results are as follows:

- In all ISE multiply-traded options, 3.3 percent of our contract volume was flashed, and 2.2 percent of our volume was traded in the auction (that is, approximately 63 percent of the volume flashed was executed pursuant to the flash). Of the amount flashed, 3.1 percent received price improvement. The average price improvement over the NBBO per contract was \$2.03.
- We further subdivided the flashed volume into options trading in pennies and those trading in nickel/dime increments. As we expected, there was a higher percentage of price improvement in penny names, where the minimum amount of price improvement is lower. On the other hand, the absolute amount of price improvement in penny names was less due to the smaller increments by which members could improve prices. Specifically:
  - We flashed 5.3 percent of the volume in penny names, executed 3.3 of the penny volume in the flash (62 percent of what was flashed), with 3.4 percent receiving price improvement averaging \$1.28 a contract.
  - In non-penny names, we flashed 1.7 of the volume, executed 1.1 percent of the volume in the flash (64 percent of what was flashed), with 2.3 percent of the contracts receiving price improvement averaging \$4.68 a contract.

This shows that flash orders provide public customers with meaningful price improvement over the NBBO. It further shows that the opportunity for price improvement

increases in penny names. With the expansion of the options penny pilot now under way<sup>10</sup>, banning flash orders will deny investors this significant and concrete benefit.

In addition, as the Commission notes in the Approval Order, flash orders can lower overall costs to investors. For example, the ISE does not charge its members for the execution of public customer orders. In contrast, if a better price is available at an exchange that charges for such executions – such as exchanges that have “maker-taker” fee structures<sup>11</sup> – the broker-dealer would have to pay to receive an execution at a price that is available without a fee on the ISE. And in some cases the broker-dealer will pass those costs through to the ultimate customer. Similarly, by maintaining the execution “in-house,” flash orders also provide public customers with more speedy and certain executions. Rather than having to reroute orders to away markets, the customer can receive an execution in the original market in which the broker entered the order.

Taken as a whole, flash orders benefit the market by enhancing competition. The primary beneficiaries of this heightened competition are the very public customers who are the focus of the Commission’s attention. Customers have the assurance that they will receive an execution at least equal to the NBBO.<sup>12</sup> With that protection in-hand, flash orders enhance the market by opening the door to the additional benefits that enhanced competition can provide. This is not limited to price improvement, speedier executions, and lower execution costs. It also includes greater customer service as exchanges compete to be the destination of choice for order flow providers. Banning flash orders would eliminate these benefits and focus all competition on a single dimension: advertising the best price without regard for transaction fees, rebates paid to the traders advertising these prices, customer service, and trade resolution services such as obvious error rules.

#### B. The Stated Problems with Flash Orders – and How to Address Them

The Release reviews the history of flash orders, noting its roots in floor-based auctions where members announce orders to the crowd before executing those orders. Recognizing that the “overwhelming majority” of trading volume today is conducted through highly-automated systems, the Commission first questions whether there is a continued need for a quote rule exemption for flash orders. The Commission is concerned that continuing that exemption: could discourage the display of limit orders, thus harming quote competition by undermining the incentives to provide firm orders and quotes; could lead to the creation of a two-tiered market in which the public has access to less information than professionals; and could result in recipients of flash orders acting in ways that disadvantage the flashed order.

We first note that these concerns are hypothetical. The Commission has not identified any situations in which there has been a misuse of flash orders. Nor has the Commission presented any evidence that flash orders have harmed quotation quality or competition. Nevertheless, we do appreciate the potential for problems in this area and the Commission’s concern in addressing potential problems before there is actual harm to investors. We thus focus on these concerns, and how best to address such concerns short of a ban.

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<sup>10</sup> See Release No. 34-60711 (September 23, 2009), 74 F.R. 49419 (September 28, 2009).

<sup>11</sup> For example, NYSE Arca generally charges \$.45 a contract “taker” fees.

[http://www.nyse.com/pdfs/Options\\_Fee\\_Schedule.pdf](http://www.nyse.com/pdfs/Options_Fee_Schedule.pdf).

<sup>12</sup> In equities, see Rule 611 of Regulation NMS; in options, see, e.g., ISE Rule 1901.



The Commission initially questions the need for a continued quote rule exemption for flash orders given the electronic nature of trading. In particular, the Commission is concerned that flash orders create a disincentive to quote aggressively in an automated market environment. On the other hand, floor-based trading traditionally has offered “flash orders” as a way to seek price improvement for customers through floor-based auctions. Exchanges continue to seek those benefits either by combining floor-based auctions with automated trading in “hybrid” environments or by creating automated auctions – like flash orders – to emulate the benefits that floors can provide. As noted above, these auction do provide price improvement.

In addition, flash orders actually raise fewer issues in an automated environment than on a floor by limiting the disincentives to quote aggressively. Exchanges members traditionally announced (effectively “flashed”) all orders, and only to the select group of professionals in a particular trading crowd. In that situation, members of the crowd have little incentive to quote their best price since they are guaranteed to see all orders before execution. In contrast, in markets like the ISE, we automatically execute all orders marketable on the ISE at the NBBO, and flash only when we cannot provide an immediate execution. Due to the competitive nature of our market, our quotes comprise the NBBO approximately 90 percent of the time. We thus flash orders only 10 percent of the time, when we are not at the NBBO.

Based on this market structure, if a market maker is not quoting aggressively nearly 90 percent of the time when there is no order flashed, the market maker would not trade with an incoming order. That is, since they do not know when an order will arrive, a market maker must quote aggressively notwithstanding the existence of flash orders. Thus, we do not believe that flashes decrease incentives to quote aggressively when a market flashes orders only in limited situations, as is the case in today’s automated markets.

The Commission also expresses concern that flash orders can lead to two-tiered markets, with only professionals seeing the flash information. However, rather than ban flash orders, the Commission can address this concern by ensuring that all market participants have access to flash information, including orders announced on an exchange floor. That is, make flash orders public. Given that only a subset of market participants see flash orders because they are not included in disseminated quotations, including flash information in the quotation stream would address this issue. Simply because quotation mechanisms now only include priced interest does not preclude adapting those systems to handle flash orders and other market innovations.

Banning a practice because it does not fit into pre-existing regulatory models is short-sighted. We believe it is preferable to adapt the regulatory model to accommodate innovative market developments. Indeed, the quotation systems already can handle market information other than traditional quotations.<sup>13</sup> Exchanges can use this flexibility to disseminate flash orders while working on even more advanced methods to include them in the quotation stream. Doing so would address two of the perceived problems with flash orders: the two-tiered market and incentives to provide public quotations. All market participants would have access to the same information and all market participants would be able to disseminate their trading interest, both in anticipation of order flow and once an order is flashed in an auction. The speed at which firms would be able to respond to flashes would be exactly the same as the speed at which they could respond to quotation updates, so no market participant would face any disadvantages.

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<sup>13</sup> See, e.g., Section V.(c)(iv) of the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information.

With respect to the Commission's concern that flash orders "create a risk" that flashed information "could" be used improperly, there is no evidence that this ever has occurred. Even if this is an issue, as the Commission properly notes, flash orders "are voluntary on the part of order routers."<sup>14</sup> Thus, to the extent that the Commission is concerned that some flashed orders may be disadvantaged in the market, persons entering such orders can properly weigh the plusses and minuses of the flash and make rational decisions. To the extent that there remain concerns that market participants could "front run" flash information by moving quotations or taking out other trading interest, requiring the dissemination of flash information to the entire market addresses the issue: if the information is available to all at the same time, by definition no one can "front run" the information. If there are any residual concerns, the Commission could require markets that permit flash orders to develop specific surveillance programs to address any specifically-identified problems with flash orders.

The Commission minimizes the effects of a flash order ban by stating that it "expects that any negative effect of the elimination of the exception for flash orders from the Exchange Act quoting requirements would be mitigated by the ability of market participants to adapt their trading strategies to the new rules."<sup>15</sup> However, the Commission does not elaborate on how participants could "adapt" trading strategies to meet these new requirements, or whether such adaptations may actually raise even greater regulatory concerns. Overall we do not believe the Commission has presented any compelling reason to ban flash orders.

#### C. Flash Orders Serve a Particularly Important Function in the Options Market

As an options market, we have a particular interest in ensuring that participants in our market do not lose the important benefits of flash orders. In addition to the general benefits of flash orders and the lack of any real problems with them, there are multiple reasons why options differ from equities, and why flash orders are even more important in the options market. We summarize these differences in the chart below, and then discuss them in more detail:

	Listed Equities	Listed Options
1. Fee Structures	Predominantly maker/taker.	Predominantly "classic," with minority maker/taker.
2. Fees for Customer Orders	Fee liable.	Fee-free on "classic" exchanges.
3. Pricing of Instruments	Pricing is based on inherent value of issuer.	Pricing is algorithmic, derived from the underlying security or index.
4. Number of Instruments Traded	Approximately 7,000.	Approximately 275,000.
5. Liquidity Providers	Natural order interaction; market makers provide supplemental liquidity	Predominantly market maker-provided liquidity.
6. Permitted Trading Venues	Exchanges, automated trading systems, dark pools, OTC proprietary.	Exchanges only.

<sup>14</sup> Release at 48637.

<sup>15</sup> Release at 48638.

7. Size of Market	Approximately 40,000,000 transactions a day.	Approximately 750,000 transactions a day.
8. Exchange Fees for Flash	Exchanges generally charge fees for interacting with flashed orders.	Exchanges generally waive fees for interacting with flashed orders.

Options exchanges employ one of two different fee models. ISE and a number of other exchanges use a “classic” fee structure, with fees charged generally for professional orders, but not for customer orders.<sup>16</sup> Other exchanges employ a so-called “maker/taker” fee schedule, in which orders that “take liquidity” pay a fee – including customer orders – while orders that provide liquidity receive payments.<sup>17</sup> Thus, the cost of buying an options contract quoted at the same price will differ depending on whether the order is without fee or subject to a “taker fee.” This pricing difference is especially critical in options, where the traded product derives its price from an underlying security or other instrument.

Market participants also price options pursuant to widely-accepted pricing models or algorithms. These pricing modes rely on a variety of objective criteria, such as the price of the underlying security, time to maturity, volatility and dividend payments and interest rates. The practical application of these pricing algorithms can lead to different prices for an option depending on the fee applied to trading. This is particularly true for options that trade in pennies.<sup>18</sup>

In Appendix A to this letter we provide a detailed mathematical explanation demonstrating that in some circumstances pricing algorithms can yield lower disseminated offer prices (or higher bid prices) in a maker/taker exchange compared to prices on exchanges with traditional pricing. In Appendix B we present differences between the equities and options market structures, and how maker/taker pricing affects the options market. Generally, prices are the same in both classic and maker/taker options exchanges 75 percent of the time. In those situations where maker/taker markets have superior prices, flash orders directly benefit public customers by allowing market makers on exchanges such as the ISE to match the pricing of maker/taker exchanges. In these cases the investor benefits by purchasing the option at the lower price (or selling the option at a higher price) without having to pay the taker fees.

Due to the mathematical nature of options pricing, flash orders do not affect the incentives of market makers on maker/taker exchanges to quote aggressively. In addition, maker/taker exchanges trade only when they are at the best price. Market participants will avoid those markets – and the taker fee – when an exchange with “classic pricing” is at the same price. Thus, the incentive for maker/taker markets to disseminate superior quotations is the same regardless of whether flash orders exist. This form of pricing competition is unique to the options market, and investors will lose these benefits if the Commission bans flash orders in options. The only exchanges arguing otherwise are the maker/taker exchanges.

The Commission further expresses concern that flash orders may harm quote competition. Assuming that flash orders generally trade at prices matching the best displayed

<sup>16</sup> See [http://www.ise.com/assets/documents/OptionsExchange/legal/fee/fee\\_schedule.pdf](http://www.ise.com/assets/documents/OptionsExchange/legal/fee/fee_schedule.pdf).

<sup>17</sup> See note 11, *supra*. Maker/taker exchanges can offer liquidity rebates because they charge taker fees. Thus, the members who pay taker fees – for both proprietary and customer orders – subsidize the maker fee credits. See Appendix B.

<sup>18</sup> The recent approval of an expansion of the “penny pilot” will significantly increase the number of options quoted in pennies. See note 10, *supra*.



market, the concern is that matching such prices could lessen the incentive for market makers to display their best prices in the disseminated quotation. As discussed above, we believe that such concerns are – at best – theoretical, and clearly are outweighed by the benefits of flash orders. However, we think there are distinctive aspects of the options market that significantly lessen this concern. First, and as discussed above and in the appendices, market makers derive options prices and quotations through mathematic formulae, and thus quote differently than equity market makers. Also as discussed above, if market makers do not quote aggressively they will not trade in the 90 percent of the time we do not flash orders.

In addition, the scope of the market is different. Market makers in the cash equities market provide liquidity in approximately 7,000 instruments. In contrast, there are multiple series of options on each underlying instrument, with liquidity being offered in approximately 275,000 options contracts. Options market makers thus provide liquidity to a much larger degree than equity market makers. Indeed, over 98 percent of the trading interest included in disseminated ISE quotations consists of market maker quotations, not customer (or even broker-dealer) orders. In addition, because of the large number of traded instruments there is much less “natural” customer-to-customer interaction in the options market than in the cash equities market, requiring even more market maker liquidity.<sup>19</sup>

By providing liquidity to multiple series of options on the same underlying instrument options market makers expose themselves to much greater risk than their equity counterparts. Persons “sweeping” liquidity in the options market can hit multiple quotations virtually simultaneously, requiring market makers to buy (or sell) a much higher dollar amount of securities than in the cash market. To limit their risk, market makers may limit the price or size of their quotations, depending in large part on their ability to hedge any options positions they may acquire. Flash orders help to compensate for smaller or wider quotations by allowing market makers to respond to flash orders on an order-by-order basis, limiting the level of their exposed risk. Banning flash orders in the options market will remove this liquidity from the market. It will not encourage any greater displayed liquidity as market makers cannot realistically disseminate the same level of potential liquidity in their exposed quotations.

Dispersed liquidity in a derivatives market also presents practical problems that flash orders help solve. Each time the underlying security moves market makers must update their quotations in what could be hundreds of strike prices related to the underlying security. If an exchange receives an order while quotations are updating, the disseminated price might not yet have adjusted to the new price. Flash orders provide an opportunity for market makers to provide the updated price in these instances. This is of particular concern as some options exchanges – typically the maker/taker exchanges that seek to ban flash orders – do not list all of the underlying strikes, limiting themselves to the most actively-traded options, which they can update more quickly. By listing all options series ISE caters to the interest of the long-term investor, rather than the short-term traders looking to rapidly trade into, and out of, positions in the most-actively-traded options. Ironically, banning flash orders would penalize exchanges like the ISE, which provide the customer service of listing all strikes, resulting in a longer lead time (though only micro seconds longer) to update all prices.

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<sup>19</sup> The Commission expresses concern that flashing orders on an exchange could result in market maker interaction with that order, rather than that order trading against another customer order that may be included in a disseminated quotation of a competing exchange. Release at 48636. However, because the disseminated quotations in options so heavily represent market maker trading interest that is much less of a concern in options than in equities.

As the Commission further notes in the Release, there is a marked difference in how equities and options trade: all standardized options contracts are traded on registered exchanges while equities can trade on exchanges, in the over-the-counter (“OTC”) market or simply by broker-dealers trading against orders themselves (that is, internalizing order flow).<sup>20</sup> As a result, flash orders help provide supplemental liquidity in options that is available through other means in the cash equities market.

In the equities markets, firms can trade against their own order flow (or order flow channeled to them in private arrangements) without any exposure of such orders to the marketplace. This provides an important form of liquidity. The equities market also includes numerous “dark pools” that broker-dealers can access in a quest for liquidity before sending an order to an exchange.<sup>21</sup> In both of these cases the persons providing liquidity do not have to display publicly the availability of trading interest prior to receiving an order. While we recognize that the Commission has requested comment on dark pools, we believe that this market structure works for equities because of the size of that market: 40 million transactions a day in 7,000 securities, leaving a very liquid and competitive market, even after orders may find liquidity in dark pools, and never reach an exchange for execution.

In contrast to these sources of liquidity in equities, all transactions in standardized options must occur on exchanges. Flash orders have developed in part to provide complementary sources to traditional quoted liquidity in a transparent environment. While internalization can occur in options, it occurs in a much more limited context and only through more transparent mechanisms conducted pursuant to exchange auction rules that the Commission must approve. We address this issue in more detail in Appendix B. Such additional liquidity is extremely important in the options market, which averages only 750,000 transactions a day spread out over 275,000 securities. It is too small a market to use the equities model described above.

Banning flash orders will not eliminate the need for this liquidity in options. Rather, such a ban is more likely to lead to the development of less transparent trading mechanisms, or the transfer of volume from the public, transparent market to the opaque and relatively unregulated market for non-standardized OTC options. We strongly believe the Commission should work to make flash liquidity more transparent in options by working to integrate flashes into the national market system’s disclosure mechanisms, rather than creating incentives for market participants to move this liquidity into non-transparent venues.

Finally, we note differences in fees between equities and options intended to ensure that customers get the best price as quickly as possible. Our payment for order flow program does not cover flash orders, meaning that we do not impose payment for order flow charges on market makers that step up to execute a flashed order. Furthermore, while equity markets may impose a charge for interacting with flash orders, at the ISE we exempt members from transaction fees when stepping up and providing customers with a superior execution. Our goal is to create incentives to increase the interaction rate of these orders, and to provide investors with as quick and low-cost an execution as possible. We do not seek to benefit financially from these orders and we do not seek to benefit the firm sending in the order.

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<sup>20</sup> The Commission specifically notes these differences and asks for comment on whether these differences should result in different treatment of flash orders in the equity and options markets. Release at 48460.

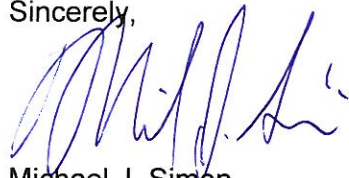
<sup>21</sup> See note 2.

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The Release does not provide a compelling case for banning flash orders. Like short selling, triple witch issues and insider trading, at most flash orders raise issues that the Commission can address through targeted regulatory actions well short of a ban. However, if the Commission ultimately does decide to adopt a flash order ban, that ban should apply only in the equities market. There are significant differences between the equity and options markets. Due to structural differences in these markets, flash orders do not pose the same theoretical problems in options, and provide greater benefits to the participants in that market. We thus believe that a ban of flash orders in options would be especially harmful to investors.

We again thank you for the opportunity to comment on the Proposal. If you have any questions on our comments, or if we can be of further assistance to the Commission, please do not hesitate to contact us.

Sincerely,



Michael J. Simon  
Secretary

Appendix A: Maker Taker Fees Can Effect Options Pricing

Appendix B: The Illusion of Maker Taker Markets

cc: Hon. Mary L. Schapiro, Chairman  
Hon. Luis A. Aguilar, Commissioner  
Hon. Kathleen L. Casey, Commissioner  
Hon. Troy A. Paredes, Commissioner  
Hon. Elisse B. Walter, Commissioner  
Robert W. Cook, Director, Division of Trading and Markets  
James Brigagliano, Deputy Director, Division of Trading and Markets  
Elizabeth King, Associate Director, Division of Trading and Markets

Maker-Taker Fees Can Effect Options Quotations and Pricing

Options market makers derive their displayed quotes using a variety of pricing algorithms. These algorithms are mathematical models whose output is a theoretical value that is then rounded to an acceptable price (based on the permitted tick increment) that is then displayed in the options marketplace.

For example, consider an options market maker who takes the following variables into account when calculating fair value: Stock price, strike price, time to maturity, dividend payment stream, interest rate (cost of carry) and volatility, the classic inputs into options pricing models. Assume that the fair value for the "ask" price of an option is \$2.035 (when multiplied by 100 for a contract representing 100 shares the true value is \$203.50). Further assuming that the option trades in penny increments, the offer price that this market maker might display to the market would be \$2.04. Entering a maker rebate of \$.30 per contract (covering 100 shares, so it is not multiplied by 100) into his modeling algorithm results in a theoretical value of \$2.0320 (\$203.50 - \$.30) which would then round to a displayed value of \$2.03. The maker rebate thus changes the market maker's quote.

This happens every day. In fact, that is the advertised advantage of the maker/taker model: it can create a tighter market. Of course, it does not happen all the time since it depends on mathematical rounding. If the original theoretical value of the option was anywhere from \$2.0280 to \$2.0379 the market maker with no rebate would round the displayed market to \$2.04, and the market maker with the \$.30 rebate would have a superior quote of \$2.03 (since his theoretical values would be anywhere from \$2.0250 (\$2.0280 minus \$.0030) to \$2.0349 (\$2.0379 minus \$.0030)).

On the other hand, if the original theoretical value of the option was anywhere from \$2.0380 to \$2.0449 the market maker with no rebate would round the displayed market to \$2.04, and so would the market maker with the \$.30 rebate since his theoretical values would be anywhere from \$2.0350 (\$2.0380 minus \$.0030) to \$2.0419 (\$2.0449 minus \$.0030).

Of course in this example it is no surprise that 70 percent of the time (assuming a uniform distribution of pricing over a one cent interval) the quotes are the same. This is due to the \$.30 difference. If the difference between classic and maker/taker fee structure were \$.52 then the two markets would be the same approximately 48 percent of the time.

While there are periods of time during the day when the \$.30 rebate makes no difference, there are other times where it makes a material difference and does change the displayed quote. Therefore, a rebate whose value is less than the permitted tick interval does make a material difference.

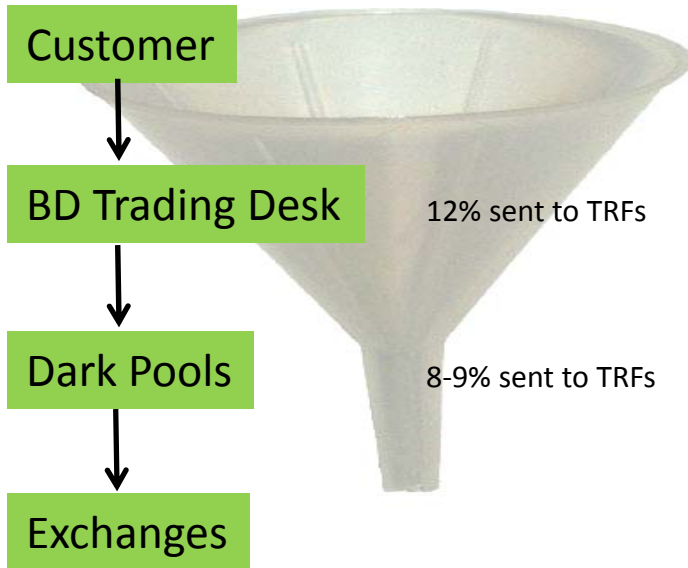


## Appendix B: The Illusion of Maker Taker Markets



The illusion of  
maker taker  
markets

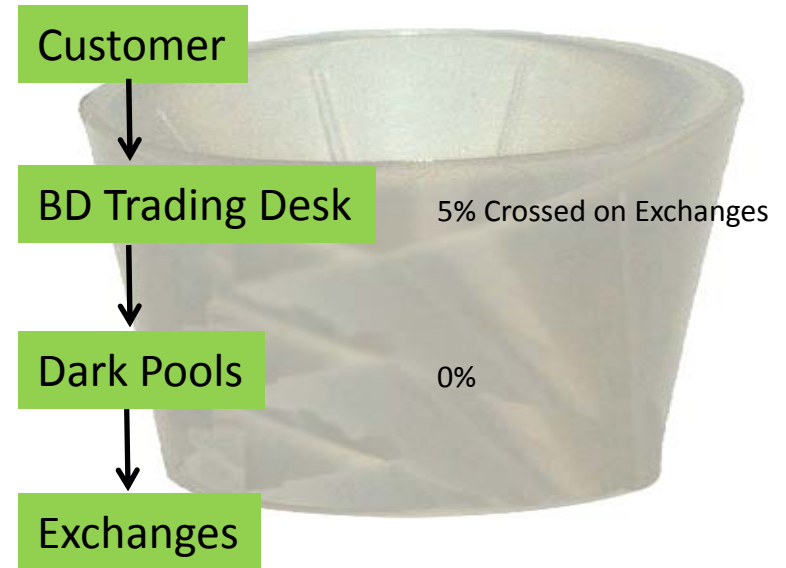
## Equities



- Funneling process removes “good” order flow
- Exchanges are left with “exhaust”
- Market makers don’t like “exhaust”
- As a result, maker taker fee structure develops in order to incent market making , i.e. two-sided markets

**This works well for equities**

## Options



- Funneling process limited to only large orders
- Exchanges have “good” order flow
- Market makers make money trading good flow
- As a result, “classic fee” structure where market makers are still willing to pay to trade with incoming order flow remains strong

**This works well for options**

In equities, payment for order flow and preferencing takes place before the order gets to the exchange. A large amount of “good” flow is internalized.

This “works” because there is still enough flow coming to the exchanges.

(7000 securities, 40 million transactions daily)

In options, payment for order flow and preferencing takes place after the order gets to the exchange. The SEC’s sanctioned balance allows for some on-exchange internalization while keeping the flow in the market for price discovery and competition.

This works because there is not enough flow in options for the equity market model to work.

(275,000 securities, 750k transactions daily)



Fact:

Because options are derivative instruments, providing a market maker a rebate of \$0.30 allows a “maker” to improve the quoted market.

This is based on fair value mathematics and has been empirically proven in the market place.

Today, we see that maker taker markets are better than “classic fee” markets between 15% and 25% of the time.

Myth:

If you allow “Flash,” maker taker market makers will not improve their quoted market. That is, “Flash” discourages competitive quoting.

Fact:

Options are a derivative instrument – mathematically, with a rebate, a market maker’s model improves the quote a certain percentage of the time dependent on the size of the rebate.

Where does everyone sit on the see-saw?

In a maker taker market, larger maker rebates produce better quotes but require higher taker fees..... as they increase, the SEC will hear calls for a “cap” from “Classic” market makers and retail brokers

If the “cap” is made too high, it is harder for “classic” market makers to match the improved quotes and retail brokers do not want to pay high taker fees. Also, too high a “cap” distorts price transparency.

If the “cap” is made too low, maker taker market makers can’t improve the quality of the quote often enough.



**A balance with both structures is good for the industry**

## Maker – Taker Pricing

# 75%

## “Classic” Pricing

of the time the quotes are the same

Who receives fee for a trade:

Market Maker	\$0.30
Exchange	\$0.15
	<u>\$0.45</u>

Who pays fee for a trade:

Broker	-\$0.45
Customer	-\$0.00
	<u>-\$0.45</u>

Who profits from the trade/spread:

Market Maker	\$0.60
--------------	--------

(MM makes total of \$0.90)

Who receives fee for a trade:

Broker (PFOF)	\$0.25
Exchange	\$0.08
	<u>\$0.33</u>

Who pays fee for a trade:

Market Maker (Fee + PFOF)	-\$0.33
Customer	-\$0.00
	<u>-\$0.33</u>

Who profits from the trade/spread:

Market Maker	\$0.60
--------------	--------

(MM makes total of \$0.27)

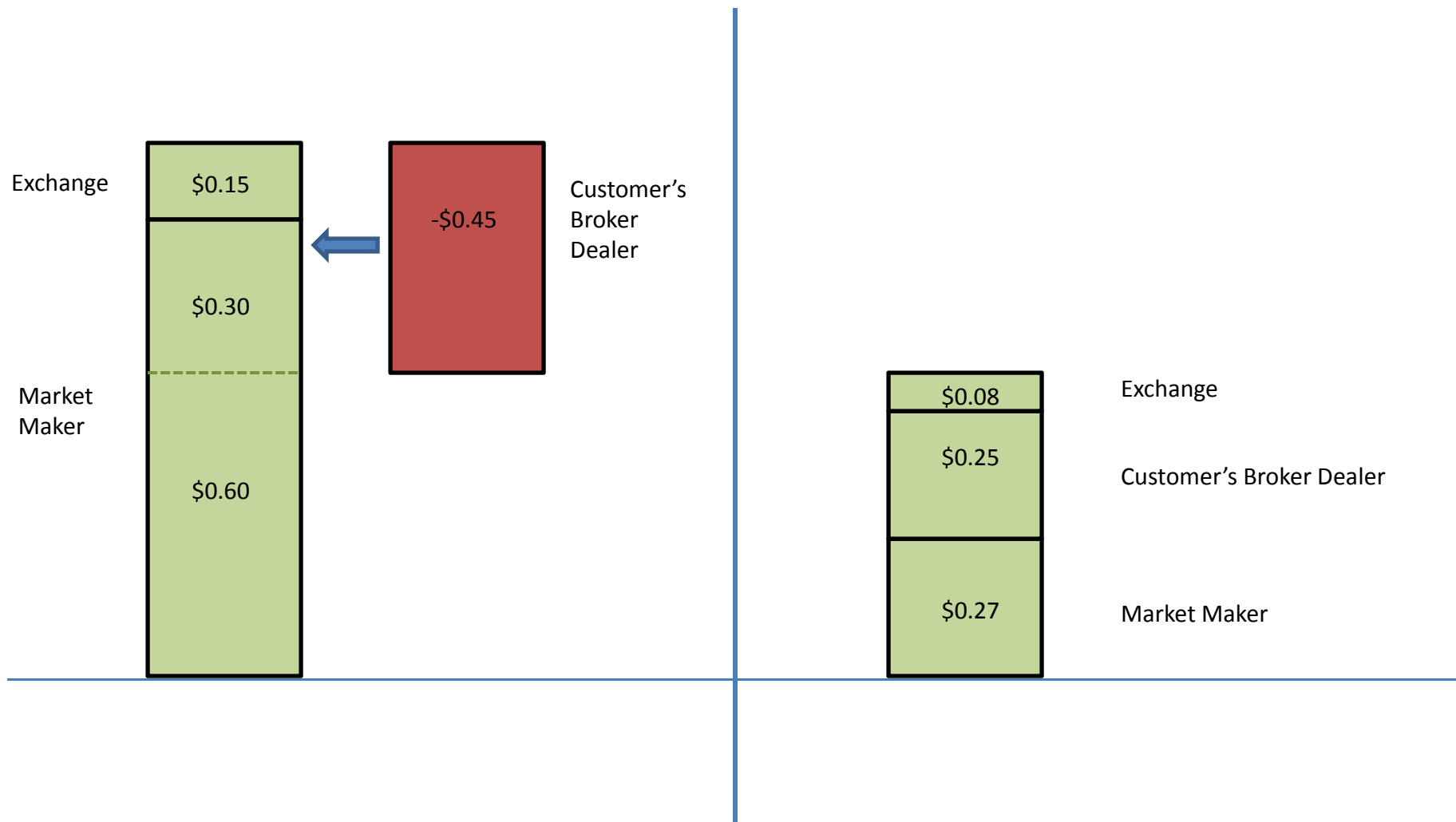


Maker – Taker Pricing

75%

“Classic” Pricing

of the time the quotes are the same



Prices vary based on the exchange, market maker expertise, transaction volume and PFOF arrangements

So, if a market maker in a “classic fee” structure only makes \$0.27 vs. \$0.90, why do they stay there?

Why don't they go to a maker taker market where the yield is higher?

In a “classic fee” model, pro-rata combined with preferencing allows the market maker to trade more often in greater size allowing them to make the \$0.27 more often with better control of risk.

## Maker – Taker Pricing

# 25%

## “Classic” Pricing

of the time the quotes are different

When Flashed

Who receives fee for a trade:

Market Maker	\$0.30
Exchange	<u>\$0.15</u>
	\$0.45

Who pays fee for a trade:

Broker	-\$0.45
Customer	<u>-\$0.00</u>
	-\$0.45

Who profits from the trade/spread:

Market Maker	\$0.10*
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(MM makes total of \$0.40)

Who receives fee for a trade:

Broker (PFOF)	\$0.00
Exchange	<u>\$0.00</u>
	\$0.00

Who pays fee for a trade:

Market Maker (Fee + PFOF)	-\$0.00
Customer	<u>-\$0.00</u>
	-\$0.00

Who profits from the trade/spread:

Market Maker	\$0.10*
--------------	---------

(MM makes total of \$0.10)

\* In both cases, assumes some edge is lost when the quote is improved by a penny

Prices vary based on the exchange, market maker expertise, transaction volume and PFOF arrangements

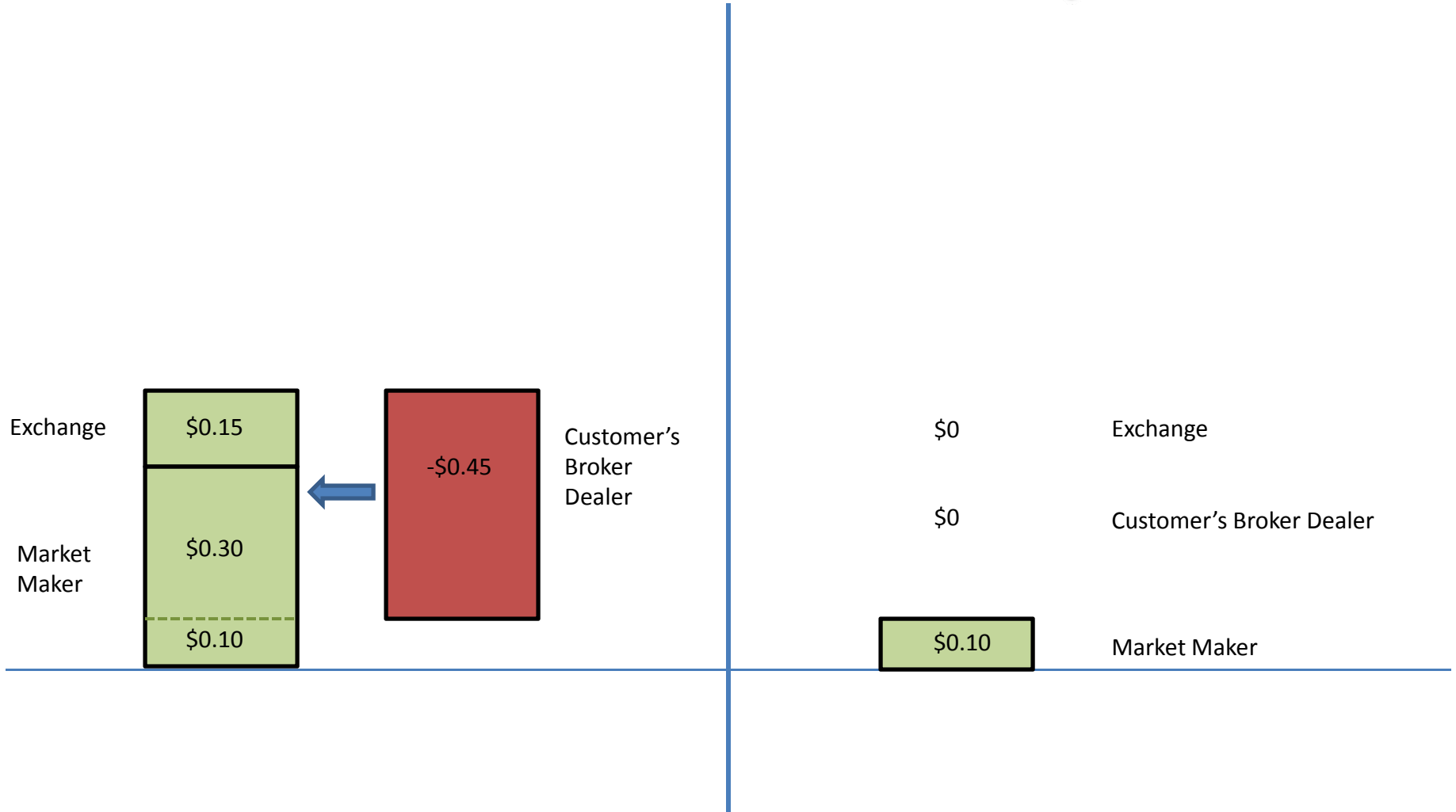
Maker – Taker Pricing

25%

“Classic” Pricing

of the time the quotes are different

When Flashed



Prices vary based on the exchange, market maker expertise, transaction volume and PFOF arrangements



Maker – Taker Pricing

25%

“Classic” Pricing

of the time the quotes are different

NO FLASH

Who receives fee for a trade:

Market Maker	\$0.30
Exchange	<u>\$0.15</u>
	\$0.45

Who pays fee for a trade:

Broker	-\$0.45
Customer	<u>-\$0.00</u>
	-\$0.45

Who profits from the trade/spread:

Market Maker	\$0.10*
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(MM makes total of \$0.40)



\* Assumes some edge is lost when the quote is improved by a penny

Prices vary based on the exchange, market maker expertise, transaction volume and PFOF arrangements

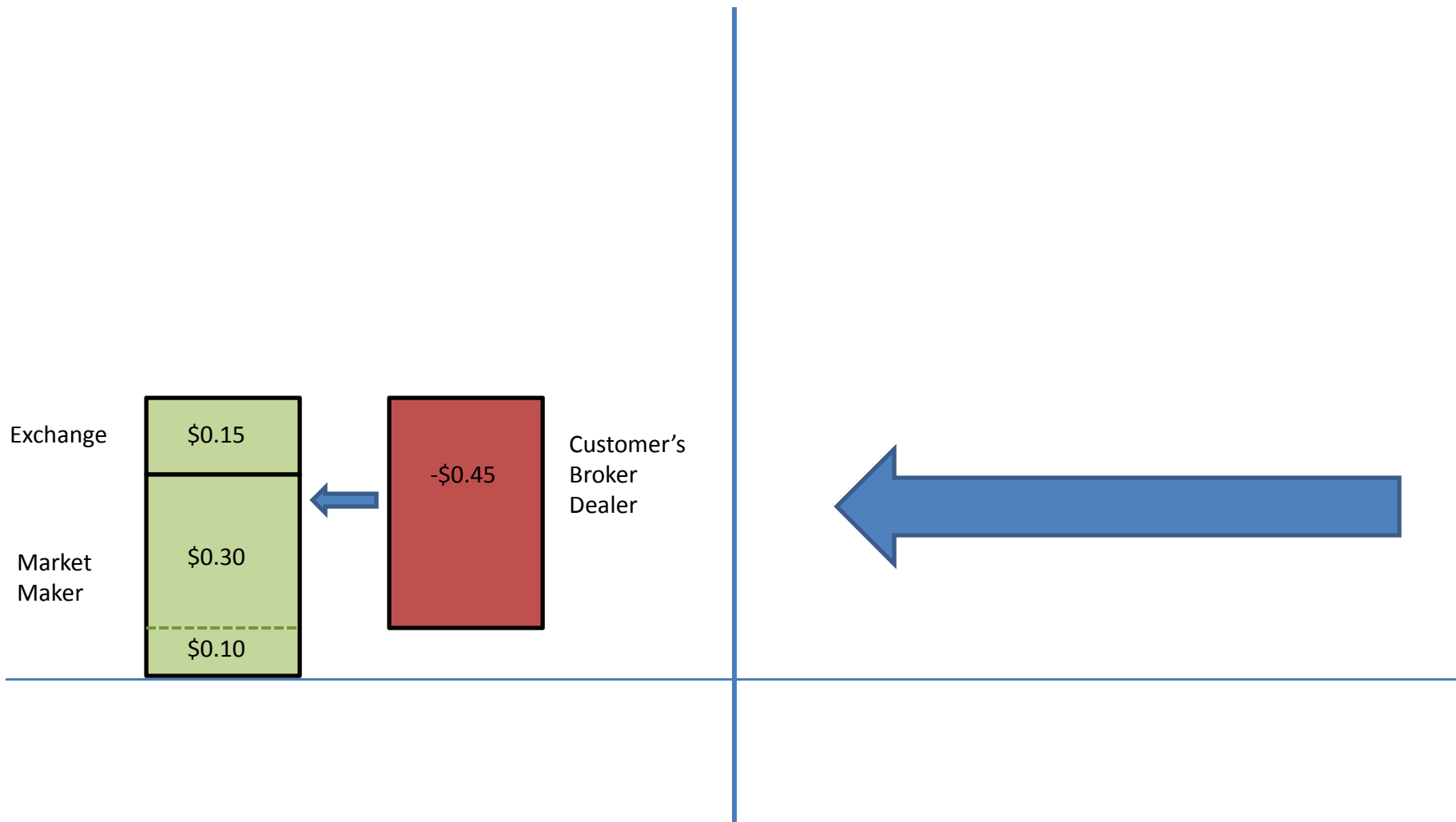
Maker – Taker Pricing

25%

“Classic” Pricing

of the time the quotes are different

NO FLASH



## Banning Flash in Options:

- Rewards maker taker exchanges
  - Rewards maker taker market makers
  - Penalizes “classic fee” exchanges
  - Penalizes retail brokerage firms
- 
- This will negatively affect retail customers