



GLOBAL ELECTRONIC TRADING COMPANY

September 2, 2008

Florence E. Harmon  
Acting Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549

**Re: Comments Regarding NYSE Arca's Proposed Rule Change to Amend its Schedule of Fees and Charges (SR-NYSEArca-2008-075)**

Dear Ms. Harmon:

I. Introduction

Global Electronic Trading Company ("GETCO")<sup>1</sup> appreciates the opportunity to comment on NYSE Arca's proposed rule change to amend its Schedule of Fees and Charges for Exchange Services and, in particular, the questions for which the Securities and Exchange Commission ("Commission") requested comments relating to the impact of the use of "maker-taker" pricing by options exchanges on quoted prices and spreads in the options markets as well as whether there should be a limit (i.e., a "fee cap") on the maximum fee that NYSE Arca, or any options exchange, can charge for access to its quotations.

GETCO strongly believes that the advent of maker-taker pricing in the options markets by NYSE Arca, the Nasdaq Options Market ("NOM") and the Boston Options Exchange ("BOX") has resulted in numerous benefits for the options markets generally and for customers trading on those markets. GETCO further believes that imposing artificial restrictions on maker-taker exchanges, such as restrictive fee caps, will reduce or eliminate many of those benefits and disadvantage retail investors. GETCO feels compelled to submit a comment letter on this proposed rule change and the related questions posed by the Commission regarding maker-taker pricing in the options markets because the debate on these issues continues to ignore or obscure an important fact: *options investors, including retail investors, are receiving better executions because of the price competition that results from liquidity providers making markets in penny increments on maker-taker options exchanges.* Rather than focusing on this important point, the debate on fee caps and maker-taker pricing has devolved into specious arguments by various market participants that maker-taker pricing has increased the incidence of locked and crossed markets in the options markets and arguments by retail options brokerages that, without fee caps, they can not lower

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<sup>1</sup> GETCO, with offices in Chicago, New York, London and Singapore is a privately-held, electronic trading firm that provides liquidity to exchanges and Alternative Trading Systems ("ATSS") in the US, Europe and Asia. GETCO, an early entrant in electronic trading, utilizes automated trading models to trade on various exchanges and ATSS. GETCO is a registered market maker on various exchanges including Nasdaq and NYSE Arca.

commissions or provide customers with free education seminars. Most market participants who participate in the debate on issues related to options market structure also routinely avoid discussing the enormous conflicts of interest associated with the receipt of payment for retail options order flow which, today, is responsible for a disproportionate amount of revenues for many retail brokerages. GETCO believes that these conflicts are so significant that retail options investors are left with few advocates for their interests in debates related to options market structure.

The Commission should not be surprised that few market participants engaging in this debate highlight the fact that retail options investors are finally enjoying the prospects of substantial price improvement and better executions provided by maker-taker exchanges, because market makers that pay for retail customer orders and brokerages that enjoy a bonanza from options payment for order flow have a great deal to lose. Market makers stand to lose the trading profits they make by trading against retail options orders directed to their exchange specialists, and retail options brokerages stand to lose historically high payment for order flow payments. For example, we estimate that one of the largest brokerage firms for retail options orders generates more than 60% of its payment for order flow revenue from its customers' options orders compared to its customer's equity orders (\$78 million annually for options payment for order flow versus \$45 million annually for equities payment for order flow), but options orders comprise only 12% of the firm's overall orders.<sup>2</sup>

The amount of revenues generated by payment for order flow in the options market is at historically high levels and should serve as a compelling impetus for the Commission to make policy decisions that will improve the competitive landscape in the U.S. options markets and, more importantly, improve the prospects that retail options investors will enjoy the higher quality of executions that retail investors routinely receive in the U.S. equity markets. The Commission's options penny pilot has dramatically improved the competitive landscape for options trading and significantly improved execution quality for retail investors. However, the imposition of fee caps on maker-taker exchanges would be an enormous step backwards and would serve to decrease competition among liquidity providers, such as GETCO, who are determined to make tighter markets that invariably result in better executions for all options investors, including retail investors.

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<sup>2</sup> We estimate the amount that TD Ameritrade receives annually in payment for order flow by referencing publicly available information (SEC Rule 606 reports, Q2 analyst conference call, and the company's SEC disclosure filings):

For equities: Average equity trade size of 340 shares and payment for order flow of \$0.002 per share resulting in average daily equity payment for order flow of approximately \$178,076 (340 shares/order (x) 0.88 (percent equity orders vs. options orders) (x) 297,588 (orders/day) ) (x) 0.002 \$178,076/day). Annual equity payments for order flow are \$45,587,000 based on the 254 trading days in 2008.

For options: Average trade size is approximately 16 contracts per order and payment for order flow on options which we estimate to be \$0.54 per contract (TD Ameritrade discloses the rate as not more than .70/contract). Resulting in the following: 16 contracts per order (x) 0.12 (percent options orders vs. equity orders) (x) 297,588 (orders/day)) (x) 0.54 (options payment for order flow rate) = \$308,539/day. Annual options payments for order flow are \$78,986,000 based on the 254 trading days in 2008.

See Appendix A for a more detailed explanation with citations.

## II. Market Forces Should Determine Exchange Fees

GETCO believes that market forces should determine exchange fees and that the Commission should not allow itself to be drawn into “rate fixing” or “price fixing”. Rather, the Commission should allow the power of free markets to set exchange pricing. As discussed below, there is no credible evidence that maker-taker pricing has caused or is causing any disruptions or distortions in the options markets. In fact, most of the available empirical evidence suggests that retail investors have benefited from the competition from maker-taker options exchanges. As such, we strongly believe that there is no compelling argument to place any caps on access fees. However, if the Commission does decide to place caps on access fees for maker-taker options exchanges, we believe that the Commission should also cap all-in access fees for traditional exchanges, regardless of the type of participant accessing the exchange’s quotation.

## III. Fee Caps Will Hurt Retail Investors

The adoption of maker-taker pricing in the options markets has resulted in significant benefits for retail options investors. GETCO strongly believes that allowing options exchanges to determine how much they are willing to pay liquidity providers as well as how much they want to charge liquidity takers will result in additional benefits for retail investors. From the perspective of retail investors, the benefits fostered by maker-taker pricing in the options markets include the following:

- Price Improvement and Better Execution -- a retail customer options order that is routed to a maker-taker options exchange that has a better price and transparent access fees that are less than the minimum trading increment will always receive a better price than on a traditional options market where payment for order flow costs skew pricing and negatively impact best execution.
- Reducing Payment for Order Flow in the Options Markets -- better pricing on maker-taker exchanges will increasingly force market makers that pay for retail options orders to send those orders to maker-taker exchanges that do not charge payment for order flow fees, decreasing market maker’s ability to pay retail brokers for order flow and increasing price improvement and execution quality for retail investors.<sup>3</sup>

GETCO strongly believes that imposing artificial fee caps on taker fees will result in worse effective and quoted spreads which will harm the quality of executions for options customers, including retail customers. The options penny pilot, and renewed competition amongst exchanges and liquidity providers, has caused the spread between the national best bid and offer to decrease \$0.04 per contract, or 56% from the pre-pilot levels<sup>4</sup>. The Commission’s Office of Economic Analysis has estimated the daily cost savings to retail customers at approximately \$500,000 per day,

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<sup>3</sup> Under exchange sponsored payment for order flow programs, an exchange will collect a fee whenever a market maker trades with a customer. The monies collected by the exchanges are aggregated and the specialist for the option class on which the fees were collected determines which customers receive payment. It is not uncommon for some specialist firms to direct all of that payment to an affiliate, which can act as a subsidy to their market making efforts. It is our opinion that these payment for order flow fees and the corresponding subsidies that specialists pay out to affiliates substantially reduces competition for liquidity provision.

<sup>4</sup> [http://www.nyse.com/pdfs/Economic\\_Capacity\\_Impacts\\_of\\_PP\\_2nd\\_Phase.pdf](http://www.nyse.com/pdfs/Economic_Capacity_Impacts_of_PP_2nd_Phase.pdf)

or \$126,500,000 annually.<sup>5</sup> The market quality improvements and resulting cost savings to the investing public are the classic example of how progressive regulations and intense competition can make markets better for retail investors, even if it puts pressure on market makers' ability to make profits.

Furthermore, as discussed in greater detail below, the opaque payment for order flow payments that traditional options markets collect and that market makers who execute on those exchanges must pay to retail brokers to attract their customer order flow is the true cause of price distortions in the options markets rather than the transparent taker fees charged on maker-taker options exchanges. Thus, GETCO believes that the issues raised by the NYSE Arca rule filing and the Commission's related requests for comment regarding fee caps present a fundamental choice between a market model that encourages payment for order flow at the expense of execution quality versus a market model that provides every incentive for a market maker or other liquidity provider to improve quoted bids and offers, which inevitably will result in price improvement and better executions for all options investors, including retail investors. We believe that both market models should be allowed to compete without imposing unnecessary restrictions, such as fee caps, so that options investors can enjoy the fruits of competition between markets. For the reasons discussed in greater detail below, we encourage the Commission to not adopt any artificial fee caps that would stifle the competition engendered in the options markets by exchanges employing the maker-taker model.

#### IV. Payment for Order Flow Distorts Pricing and Negatively Impacts Execution of Customer Orders in Options Markets

Most retail brokerage firms route their customer orders to option market makers who pay the broker for the order flow. The typical payment for order flow fees paid to retail brokers for options order flow are currently several multiples of payment for order fees that retail brokers receive for customers' equity orders. Payment for order flow for retail options orders is typically \$0.50<sup>6</sup> or more per options contract. Because of the enormous payment for order flow demanded by retail brokerages, market makers who pay for order flow invariably have difficulty matching the better prices available on a maker-taker exchange while still making a trading profit.

To better understand this point, it is necessary to analyze the execution of a typical retail customer options order while also understanding the role of options market makers. Options market making is relatively straight forward once a market maker determines a theoretical value for the options contract for which he makes a market. A market maker will make three basic adjustments to the theoretical value to arrive at his two sided quote. These adjustments account for exchange fees, payment for order flow obligations, and trading profits. On a traditional exchange, the fee adjustment is \$0.21 per contract (the typical exchange fee) and a payment for order flow adjustment of \$0.25 per contract. Here we will also assume that the market maker is looking for net trading profits of \$0.50 per contract.

- On a traditional exchange, the market maker's bid and offer prices are each adjusted \$0.96 away from the theoretical value ( $\$0.21 + \$0.25 + \$0.50$ ) and a market can be made accordingly.

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<sup>5</sup> <http://www.sec.gov/news/speech/2008/spch050208ers.htm>.

<sup>6</sup> Payment for order flow comes from two primary sources; exchange facilitated programs and optional direct payments from market makers.

- On a maker-taker exchange, where the exchange fees are a credit for providing liquidity and there are no payment for order flow obligations, that same market maker adjustment is only \$0.15 away from theoretical value (\$0.50 trading profit-\$0.35 liquidity adding credit + \$0.00 payment for order flow).

Therefore if the theoretical value for an options contract were \$2.065 the markets would be as follows where Exchange Z is the maker-taker exchange and Exchange A is the traditional exchange.

| Exchange | Bid     | Offer   | Exchange |
|----------|---------|---------|----------|
| Z        | \$ 2.06 | \$ 2.07 | Z        |
| A        | \$ 2.05 | \$ 2.08 | A        |

### Conclusions:

- Increased competition from maker-taker exchanges will cause market makers to improve displayed bids and offers. This will in turn result in a better price for retail customers, such as in this example where the customer selling a contract receives \$206 for the contract on Exchange Z as opposed to \$205 for the contract on Exchange A.
- Market makers that pay for order flow on Exchange A will have difficulty matching the better price on Exchange Z because the market maker is saddled with Exchange fees and payment for order flow costs of almost a \$0.25 per contract.<sup>7</sup> In the aggregate, the increased competition from Exchange Z costs a market maker on Exchange A nearly \$1.50 to match the NBBO, execute at the better price and pay for the order on Exchange A. Thus, the improved price at Exchange Z hurts market makers that are paying for order flow on Exchange A because they must either route to a market that charges a taker fee, while the market maker still has to pay payment for order flow to the retail brokerage who directed the order to the market maker on Exchange A, or execute on Exchange A at a price that is higher than makes any economic sense for the market maker. As such, the market maker that is paying for order flow would rather that Exchange Z not incentivize other market participants to increase the bid displayed on Z. This is why a market maker that pays for order flow would be in favor of fee caps - that is, these market makers want fee caps so that Exchange Z will have less means to pay the higher rebates to liquidity providers that encourage better displayed prices and narrower spreads.
- In the example above, if a market maker on Exchange A has to pay the \$0.55 taker fee and then is still required independently to make a payment for order flow payment to the retail broker who sent the order to the market maker, then the economics for the market maker on Exchange A become even worse. Clearly these economics for market makers that pay for retail order flow are not sustainable and put pressure on market makers executing on Exchange A to reduce payment for order flow payments to retail brokers. If, realizing this, the market maker decides that it can no longer both pay for order flow and the taker fee, it

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<sup>7</sup> Traditional exchanges have implemented “step-up” programs that attempt to mitigate the fee differential with maker-taker exchanges by waiving exchange fees and payment for order flow fees. We believe that “step up” programs, which can delay executions for customer orders, are contrary to the general duty of best execution and that these kinds of step-up programs would not be tolerated in the more competitive equity markets.

could decide to pass along the taker fee charged on Exchange Z to the customer. This is illustrated by the following chart:

| <b>Without competition from maker taker exchanges</b> |          | <b>With competition from maker taker exchanges</b> |          |
|---|----------|--|----------|
| NBBO is Exchange A                                    |          | NBBO is Exchange Z                                 |          |
| Exchange Fees   | \$0.21   | Exchange Fees                                      | \$0.55   |
| PFOF  | \$0.25   | PFOF   | \$0.00   |
| Cost for 1 contract                                   | \$205.00 | Cost for 1 contract                                | \$206.00 |
| <br>  |          | <br>   |          |
| Total Cost to MM                                      | \$0.46   | Total Cost to MM                                   | \$0.00   |
| <br>  |          | <br>   |          |
| Execution cost to Customer                            | \$0.00   | Execution cost to Customer                         | \$0.55   |
| <br>  |          | <br>   |          |
| Proceeds to Customer                                  | \$205.00 | Proceeds to Customer                               | \$205.45 |

- As demonstrated above, even if the taker fees are passed on to the customer, the Customer will still receive \$0.45 more for the contract on Exchange Z than on Exchange A. A rational customer will always choose to receive a better price as long as the fees associated with obtaining that better price are less than the increased execution value. Moreover, \$0.45 per contract is a material amount of price improvement that any retail brokerage should attempt to obtain for its customers. Price improvement of this magnitude would likely result in tens of millions of dollars, or more, in price improvement annually for retail customers.

#### V. Higher Taker Fees Will Put Pressure on Payment for Order Flow Arrangements

As illustrated above, market makers who are obligated to make payments in order to attract order flow face a difficult economic choice - improve their bids and offers to match the better priced NBBO available on a maker-taker market at a loss, or route the order to the market showing the better priced bid or offer. Market makers could easily route the order to the maker-taker exchange and obtain a better price for the retail customer. However, this alternative leaves the market maker with a dilemma, as it will be charged a taker fee for accessing the better quote on the maker-taker market, which would diminish or eliminate the profitability of the transaction for the market maker. However, there are no rules or regulations that prohibit market makers who pay for order flow from passing on to the customer the fees associated with obtaining better prices at maker-taker exchanges. The retail customer will receive a better price and a better net payout on a maker-taker exchange than under a payment for order flow model, because the price improvement of a minimum increment on the competing maker-taker exchange will more than make up for the taker fee that is passed along to the customer, which is demonstrated in the illustration above. As maker-taker exchanges attempt to compete for liquidity provided by market makers by raising taker fees to pay higher rebates to liquidity providers, the higher taker fees will cut further into the profits of market makers that pay for order flow. As such, the raising of taker fees by maker-taker options exchanges will put more pressure on payment for order flow arrangements while promoting better executions for retail customers

While the Commission has routinely expressed its concern about the potential distortive effects payment for order flow would have on the options markets, it has understandably refrained from limiting or eliminating it so that market forces could best determine the propriety of the practice. One of the primary reasons that payment for order flow has thrived so long in the options market is that, until recently, there have been no competing business models. As the Commission noted in its March 8, 2007 Report<sup>8</sup> related to options order routing, five of the then six options markets all had established payment for order flow programs. Since that time, however, three exchanges now employ a maker-taker model, which has finally brought significant competition to the traditional exchanges payment for order flow model. GETCO strongly believes that increased competition from maker-taker exchanges will result in lower payments for order flow and better executions for retail options orders. This conclusion is supported by the current state of affairs in the equity markets, where, for example, market makers generally do not pay for order flow for price improved orders. This dynamic of better prices for retail customers and lower payment for order flow rates is likely to take hold in the options markets if the Commission allows maker-taker exchange competition to continue and expands the penny pilot program.

#### VI. Maker-Taker Models Do Not Lead to Locked and Crossed Markets

Another issue raised in the Commission's requests for comments on the proposed rule change is what impact higher maker-taker rebates and fees will have in terms of causing options markets to lock or cross. Some market participants argue that, absent a reasonable limit on taker fees, maker-taker fee structures encourage market participants to lock or cross the market. This argument is simply a red-herring. Each of the maker-taker options markets (NYSE Arca and NOM) have implemented automated systems that utilize specific logic to reject orders that would lock or cross the market for an options class listed on those exchanges. As such, if locked or crossed markets are more prevalent in the options markets, they are only being caused by market makers on the traditional exchanges which do not systemically prevent locked or crossed markets.

#### VII. Conclusion

GETCO believes that the options markets are entering an exciting new phase of competition. We believe that such competition will enhance efficiency in the marketplace, foster the provision of much needed liquidity and, most importantly, provide options customers with better and better executions. Accordingly, we encourage the Commission to expand the penny pilot and forego introducing any artificial fee caps into the current competitive environment or sanctioning any other actions that would restrict the further development and evolution of maker-taker pricing models in the options markets.

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GETCO appreciates the opportunity to submit these comments. Please do not hesitate to contact us at (312) 242-4600 if you have any questions regarding any of the comments provided in this letter.

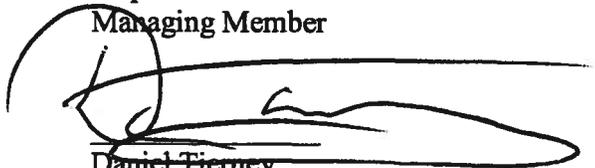
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<sup>8</sup> "Report Concerning Examinations of Options Order Routing and Execution" Office of Compliance Inspections and Examinations, Office of Economic Analysis, and Division of Market Regulation, March 8, 2007.

Sincerely,



Stephen Schuler  
Managing Member



Daniel Tierney  
Managing Member

## Appendix A

| Category                              | Revenue                 | Source   |
|---------------------------------------|-------------------------|--|
| Daily Average Revenue Trades (DARTs)  | 297,588                 | 10-Q   |
| Quarterly Transaction Based Revenue   | \$ 248,900,000          | 10-Q   |
| Trading Days                          | 64                      | 10-Q   |
| Average Commission                    | \$ 13.07                | 10-Q   |
| (%) Options Trades                    | 12%                     | Q2 Conference call (transcript available)  |
| Stock Base Commission                 | \$ 9.99                 | public rate schedule   |
| Stock Per-Share Commission            | \$ -                    | public rate schedule   |
| Stock (Per-share) PFOF                | \$ 0.002                | AMTD Rule 606<br>( <a href="http://www.tdameritrade.com/forms/CLR2054.pdf">http://www.tdameritrade.com/forms/CLR2054.pdf</a> ) |
| Average Stock Trade Size              | 340                     | estimated  |
| Average Stock Commission              | \$ 10.67                | Base + avg size * share rate + avg size * pfof   |
| Options Base Commission               | \$ 9.99                 | public rate schedule   |
| Options Per-Contract Commission       | \$ 0.75                 | public rate schedule   |
| Approximate Options PFOF Per Contract | \$ 0.54                 | AMTD Rule 606<br>( <a href="http://www.tdameritrade.com/forms/CLR2054.pdf">http://www.tdameritrade.com/forms/CLR2054.pdf</a> ) |
| Estimated Average Option Trade Size   | 16                      | Estimated  |
| Average Option Commission             | \$ 30.63                | Base + (avg size * contract rate)<br>+ (avg size * PFOF)   |
| Estimated Average Commission          | \$ 13.07                | (%) Options * Average Option Commission<br>+ (%) Stock * Average Stock Commission  |
| Estimated Commission Revenue          | \$ 248,834,991          | Estimated Average Commission * DARTs<br>* Trading Days   |
| Estimated Quarterly Stock PFOF        | \$ 11,396,906.19        |  |
| Estimated Quarterly Options PFOF      | <b>\$ 19,746,511.26</b> |  |
| Estimated Annual Stock PFOF           | \$ 45,587,624.76        |  |
| Estimated Annual Options PFOF         | <b>\$ 78,986,045.03</b> |  |