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

Re: <u>SEC Release No. 34-61902</u>

Dear Ms. Murphy:

NYSE Euronext, responding on behalf of its subsidiary options exchanges, NYSE Arca, Inc. ("NYSE Arca") and NYSE Amex LLC ("NYSE Amex"), appreciates the opportunity to respond to the proposal of the Securities and Exchange Commission ("Commission") to amend Rule 610 of Regulation NMS under the Securities Exchange Act of 1934 ("Exchange Act"). NYSE Euronext supports the Commission's efforts to continually improve the operation of the national market system, and we support the Commission's proposal to prohibit unfair discrimination. However, as we describe below, we have significant concerns about specific aspects of the Commission's proposal to cap access fees, and we particularly believe that proposed Rule 610(c)(2) could be harmful to the functioning of the U.S. listed options marketplace.

<u>Proposed Amendments to Rule 610(a)</u>

The Commission has proposed an amended Rule 610(a), which would enact a prohibition against discriminatory terms that inhibit access to quotations, particularly including extra fees for indirect access by a non-member through a member.[1] NYSE Euronext agrees that access fees should not be disproportionately burdensome to non-members. However, we strongly believe that volume-based discounts for certain customer types should not be limited, as it is appropriate to provide incentives to customers who contribute more order flow to the marketplace (irrespective of whether that order flow is "making" or "taking" liquidity, increased order flow improves the price discovery process and ultimately results in a more

[1] NYSE Arca issues Options Trading Permits ("OTPs") and NYSE Amex issues Amex Trading Permits ("ATPs") to Broker-Dealers who are qualified to be Market Makers ("MMs") or Order Flow Providers ("OFPs") who wish to effect transactions on the Exchanges Trading Facilities. Neither exchange has members *per se*, but OTP Holders and ATP Holders have the status of "members" as that term is defined in Section 3 of the Securities Exchange Act of 1934, as amended.

efficient marketplace for all participants). Such volume-based discounts or "tiers" are also consistent with established business practice in many industries and arise naturally as a result of the improved economies of scale realized by exchanges with respect to their high-volume customers: the incremental costs to the exchange of executing each additional traded contract are small relative to the cost required to bring a new customer online, institute the appropriate regulatory and surveillance practices, and provide the requisite level of customer support.

Further, we believe that it is appropriate for options exchanges to assess different fees to members executing trades in different types of accounts. The rights and obligations of customers, market makers, non-market maker broker-dealers, and firms are significantly different. For example, market makers have quoting obligations that do not apply to non-market maker broker-dealers. Accordingly, it is appropriate for an exchange to charge market makers a reduced fee versus non-market maker broker-dealers, which have the privilege of trading at times of their choosing without being required to make continuous two-sided markets.

Proposed Rule 610(c)(2)

The Commission has also proposed adding a new Rule 610(c)(2) to Regulation NMS with the intent of restricting exchange access fees that, in the Commission's preliminary view, may inhibit the functioning of exchange rules (collectively referred to as "Trade-Through Rules") intended to satisfy the trade-through provisions of the Options Order Protection and Locked/Crossed Market Plan ("Distributive Linkage") implemented in August 2009. Specifically, the Proposing Release outlines the Commission's view that the most efficient way to meets its goal is to impose a $0.30-per-options-contract cap on fees paid to access and execute against a market's disseminated best bid or offer.

NYSE Euronext believes that the proposed access fee cap is unnecessary in the extremely competitive U.S. listed options marketplace, and would be detrimental to the efficient functioning of the options markets. However, should the Commission decide to adopt a fee cap, we believe it should be (1) at an appropriately permissive level such that disruption to the ongoing successful function of the options marketplace will be minimized, (2) narrow in scope, and specifically exclusive of ancillary charges such as product licensing fees and the Options Regulatory Fee that are in some respects beyond the control of individual exchanges, and (3) enacted in conjunction with a complete ban on the related and inequitable "flash order" process undertaken by certain exchanges.

A fee cap is not necessary in the options markets

The options industry exists within a robust, competitive, innovative national marketplace. Exchanges compete vigorously for business through pricing, execution quality, advanced technology and inventive market structures. Intermarket access operated smoothly under the Plan for the Purpose of Creating and Operating an Intermarket Options Linkage ("Linkage Plan") and has improved since the adoption of Distributive Linkage. Indeed, recent events have demonstrated how well the options markets are operating: the market dislocation of May 6, 2010 resulted in the breaking of relatively few options trades, and the industry has continued to operate smoothly despite significant subsequent volatility.

To the extent that the Commission involves itself in the pricing decisions of options exchanges, the ability of the exchanges to compete for various market segments through innovative pricing will be reduced, to the ultimate detriment of customers. Currently, options exchanges operate under several different pricing structures: some exchanges charge market makers a fee but allow customers to trade for free or pay customers for their order flow, other exchanges charge a fee to liquidity takers and rebate liquidity providers, and one exchange charges a fee to liquidity providers and rebates liquidity takers. Each of these business models targets a particular type of market participant or order flow, earning a larger piece of the business from those target segments and forcing competing exchanges to find innovative ways to win that business back, ultimately driving down costs for all market participants. Imposing a narrow access fee cap would severely restrict the ability of exchanges to compete on pricing grounds, reducing the ability of exchanges to differentiate themselves from their competitors. Like any action that reduces the number of axes along which businesses can compete, this would likely lead to consolidation in the options exchange space, ultimately resulting in higher average costs to investors.

Furthermore, incentives already exist to discourage options exchanges from charging prohibitively high fees for options executions. Markets are continually refining the fee structure to attract business because the presence of liquidity attracts additional liquidity. Traders with limited resources and technology budgets seek to execute business where liquidity is already present in order to increase opportunities for profitable trades. Therefore, no options exchange can thrive by adopting a high price/low volume model. Additionally, there is already a mechanism to ensure that attempts to use pricing in a discriminatory fashion can be addressed: the process by which exchanges must publish fee filings for comment and review by the Commission staff. Given these existing incentives and mechanisms, we believe that the imposition of an access fee cap is unwarranted.

With transparency in mind, NYSE Euronext believes that, while appropriate standards should be maintained in the rule approval process, imposing a fee cap would be neither appropriate nor useful. In fact, the implementation of a fee cap on orders accessing the displayed bid or offer would create a powerful incentive to restructure the market so that orders could be matched inside the bid and offer without trading against displayed liquidity, thereby allowing for larger fees to be collected. This would be detrimental to market quality and transparency.

Finally, we submit that if the Commission feels the options industry needs less intermarket friction, there are other ways to achieve that goal, such as strengthening requirements for exchanges to have continuous markets in all series of an options class. NYSE Euronext also respectfully submits that, if the motivation for an access fee cap is simply to protect the integrity of the Trade-Through Rules, then a cap that applies only to intermarket trades would be a simple and less disruptive alternative. Intermarket trades are a small portion of the overall industry volume; a fee cap on routed orders could be implemented with little disruption to the National Market System and would allow for continued robust competition amongst the options exchanges.

If a fee cap is implemented, it should be at an appropriately permissive level

Although NYSE Euronext feels that a fee cap is inadvisable, we recognize the possibility that one may be enacted. Below, we make recommendations as to what form such a fee cap, if implemented, should take.

First, NYSE Euronext believes that the proposed $0.30 level is too low when all of the components accounting for the cost of an options transaction are taken into account. The proposed $0.30 cap is based on the analogous equities standard, but the analogy to the equities markets does not hold up under scrutiny, and we believe it should not be the guideline for the options industry. The options markets are fundamentally different in several key respects.

1. All equities priced above $1 per share trade at the same Minimum Price Variation ("MPV") of $0.01, while options contracts trade in one of three different MPVs depending on underlying class and premium of the option. Given that many options have an MPV of $0.05 or $0.10 per share on a 100-share contract, even fees substantially higher than those currently charged by *any* exchange would not materially impact the desirability of trading at one price point versus another. As long as the total access fee is less than one MPV, every customer will prefer buying a 100-share option for $1.80 to paying $1.81, and will

hugely prefer paying $5.10 to paying $5.20. Therefore, even in the presence of varying access fees, distinctions in displayed quotes remain a transparent indicator of which venue has the most attractive all-in price.

2. The equities marketplace is highly fragmented and includes venues with no order books, venues that do not report trades as they occur, venues that allow printing through the NBBO, and "dark pools" that do not publish quotes. The opacity of these portions of the equity markets leaves limitations on fees as the only way to impose some means of limited protection for quotes. The options markets, despite having a product base over 33 times greater in size than the equities markets,[2] enjoy a level of transparency that is a model for global markets: options orders must be exposed to the marketplace before execution, contracts must be executed on an exchange to be cleared by the Options Clearing Corporation, and all trades must be promptly reported to OPRA. While certain efforts have been made to diminish transparency in the options markets, the Commission has been appropriately cautious in permitting such initiatives. The highly transparent nature of the options price discovery process, the inability to print trades off-exchange, and the success of the Trade-Through Rules collectively suggest that equity-style fee caps are unnecessary to ensure a smoothly functioning marketplace. And while options exchanges may push against regulatory constraints and test the boundary between execution efficiency and transparency, the Commission staff and the options markets do so in an open manner that allows for a robust exchange of ideas and opinions.

3. Unlike equities, options prices move without transactions taking place. Equity shares will not increase in value unless someone is wishing to pay a higher price, but options prices will increase as either the price changes or the volatility of the underlying security increases, even in the absence of a trade. Therefore it is not accurate to suggest that lack of a fee cap could allow one exchange to stand in the way of price changes, acting as a "toll booth" to collect high fees—even absent a fee-generating trade, the last market maker quoting at a certain price point must eventually move his or her market in the face of shifting volatility or underlying price levels.

If the Commission proceeds to impose a cap on fees, we believe the cap should be set somewhere in the range of 80-90% of the MPV. Structuring the cap in this manner would provide a check against abusive pricing behaviors without interfering with the competitive

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2 As of May 20, 2010 there were approximately 7,883 equity products and 266,298 option series available for trading on NYSE Arca.

forces of the National Market System. Any exchange that charged such a high fee might theoretically profit from occasional intermarket trades, but would become an "exchange of last resort," resulting in a substantial reduction in volume, and customers will still prefer to trade at that exchange rather than pay through to the next, less attractive price point, preserving the integrity of the Distributive Linkage mechanism.

We further note that, as the Commission rightly points out, it is consistent with the proposed limitation on access fees to include exchange-supported marketing fee collection in the access fee cap when a new market maker order trades against an existing public customer order on top of the book. However, doing so with the cap set at the $0.30 level is not realistic without significant changes to the payment-for-order-flow system that allows liquidity providers to attract volume that has economic value to them. Existing payment-for-order-flow collection amounts are $0.25/contract for Penny Pilot issues on all exchanges that assess them. This level has been established in a highly competitive market environment based on the value of that order flow to liquidity providers, and is paid into a pool used by market makers to compensate order flow providers; these fees are not kept as profit by the exchange. Additionally, several exchanges (including NYSE Amex) charge market makers $0.15 or more per contract as part of a business model that allows retail customers to trade for free. As the sum of these charges and collection amounts significantly exceeds $0.30, an SEC mandate to include the marketing charge in a cap as low as $0.30 would necessarily have the unintended consequence of forcing exchanges to either (1) abandon the longstanding practice of charging market makers a competitive per-contract rate for their trades, (2) stop collecting marketing charges (which, again, are ultimately paid out to customers or, if unpaid, rebated back to the market makers who paid them) for trades against customer orders resting in the book, despite the economic value brought to the marketplace by such orders, or (3) end the practice of allowing retail customers to trade for free, to the detriment of the investing public, in order to prevent a precipitous decline in revenues.

<u>If a fee cap is implemented, it should be appropriately narrow in scope</u>

The Commission has proposed that the cap be comprehensive, including all costs that could be incurred by a customer accessing a displayed quote in the options market. Several of these costs, however, are effectively beyond the control of individual exchanges: these include licensing costs for proprietary index products and the Options Regulatory Fee ("ORF") assessed by some exchanges. NYSE Euronext believes that any fee cap, if implemented, should exclude these costs.

Unlike the equities markets, options exchanges list proprietary index products that require payment of fees to the index licensors. The index products to which these fees apply are particularly useful to investors for portfolio diversification and risk management. Exchanges cover these costs by passing through a portion of the licensing cost in certain cases. Although exchanges are free to structure this licensing charge as they wish, the actual license costs borne by the exchanges are generally contractually uniform across the industry. In the license agreements entered into by NYSE Euronext, for example, language known as the "most favored nation" clause requires that a lower license fee subsequently negotiated by another exchange also become applicable to NYSE Euronext markets. As other exchanges follow a similar practice, and due to competitive considerations, the end result is that the per-contract expense incurred by exchanges for transactions in the licensed products generally are equivalent.

Consequently, license fee charges are not a meaningful "hidden" differentiator when comparing displayed quotes across market centers. However, due to the terms required by index licensors, these fees can be significant in some cases (for example, NYSE Amex Options charges $0.22 per contract to non-customers trading options on the Nasdaq 100 or "NDX" index in order to defray fees assessed by Nasdaq). As a result, by imposing an low access fee cap that includes licensing fees, the Commission would effectively force exchanges to choose to either (1) subsidize the trading of licensed products at significant cost; (2) demand far lower license fee terms from index licensors, reducing the licensors' incentive to create innovative products for subsequent listing and trading and thereby hurting innovation in the options industry; (3) increase the portion of the license fee passed through to market participants that are not accessing the quote (for example, market makers, who would immediately respond by widening out their quotes, resulting in inferior execution prices for customers); or (4) delisting the licensed products, resulting in decreased competition in the product, wider bid-ask spreads, and inferior execution prices for customers on the remaining exchanges. If the average spread widens by even one-half of the smallest MPV, the average cost to an investor accessing one side of the quotation will increase by $0.25 per contract—more than the amount of the current NDX license fee.

The Commission also requested comment on extending the cap to include the Options Regulatory Fee ("ORF"), a fee currently assessed by certain exchanges on all customer trades executed by their members, including those executed on other exchanges. For example, a trade executed on NYSE Amex by a firm that is an Electronic Access Member of the ISE could result in that firm's being charged an ORF by the ISE. Because NYSE Amex has no control over the magnitude of the ORF imposed by the ISE, it would be unreasonable to cap

NYSE Amex fees in a way that included the total ORF potentially imposed by all other industry participants on each trade. The ORF should therefore be excluded from any fee cap imposed by the Commission.

The Commission also requested comment on various other situations where an access fee cap might be considered. Broadly speaking, the Commission's stated concerns relate to intermarket access and protecting the integrity of the Trade-Through Rules. In that spirit, NYSE Euronext believes that transaction fees for trades negotiated on an exchange floor, FLEX transactions for which there is no disseminated market, executions against undisplayed liquidity, executions that result in price improvement beyond the displayed quotation, or executions of orders structured such that the price cannot be reported to OPRA should not be included under the access fee cap.

Finally, NYSE Euronext does not believe the fee cap should be extended to executions against resting orders below the top level of the book. Depth-of-book orders are partially displayed liquidity beyond the exchange BBO; information about these orders is available on some markets that publish it as a proprietary feed,[3] but is not widely or uniformly disseminated throughout the industry. Further, depth-of-book orders are not currently protected—orders and quotes below the top of the book may be traded through by Intermarket Sweep Orders ("ISOs"), which only require interaction with the published best bid or offer on away markets prior to execution.

If a fee cap is implemented, "flash" orders should be prohibited

As noted in the Release, some markets use the potential cost of routing to certain away markets as a justification for internal "flashing" of orders that are marketable against the NBBO. (Neither NYSE Euronext options exchange allows these types of orders.) During the "flash," the customer is disadvantaged in that his or her order, which is not protected by a guaranteed fill, is held for a period of time while the exchange, unable to fill the customer at the NBBO at the time the order was received, allows its market participants the opportunity to belatedly step up to the NBBO price (which, by definition, is already available at another exchange) in order to prevent the order from being routed away.

[3] NYSE Arca and NYSE Amex provide depth of book information at no extra charge to anyone who wishes to subscribe to the "ArcaBook" feed. Other markets that provide similar information may or may not charge for the data.

NYSE Euronext continues to believe that flashing orders is detrimental to the National Market System, as this process delays the execution of customer orders, creates the risk that market participants who receive the flash may trade ahead of the customer order, and results in customers missing fills to which they would otherwise be entitled had the order not been delayed by the flash period. This practice should be banned irrespective of whether action capping access fees is taken. However, if fee caps are imposed, the argument that a flash process is necessary to prevent customer orders from being subject to excessive fees at other market centers would be instantly rendered obsolete—by definition, none of the capped fees will be "excessive." Therefore, if an access fee cap is imposed, a full ban on the flashing of orders should be simultaneously enacted.

Conclusion

NYSE Euronext applauds the Commission's role in shaping a U.S. listed options industry that is a world leader in openness, transparency, and competitiveness. With eight exchanges aggressively competing for business, the ongoing expansion of the penny pilot program, a wide array of market structures and pricing methodologies that appeal to a diverse range of investor groups, advanced technologies that continue to perform admirably during times of severe dislocation in other markets, and an array of innovative proprietary products, the U.S. options marketplace is a model for global markets. We respectfully urge the Commission to refrain from attempting to fix what isn't broken by imposing a highly restrictive fee cap in a way and at a level that is taken directly from the very different U.S. equities marketplace and which would have severely detrimental effects on market widths, competition, innovation, transparency, and diversity in market structure and product offerings.

It is the position of NYSE Euronext that no fee cap should be enacted—we again suggest that a simpler and less disruptive alternative would be a cap applying only to the small percentage of trades that are actually executed through the intermarket routing system. Should a comprehensive cap be imposed, however, it should be at an appropriately permissive level (we suggest 80-90% of MPV) in order to minimize disruption to market structure; it should be exclusive of fees, such as proprietary product license fees and the ORF, largely beyond the control of each individual exchange; and it should be enacted simultaneously with a ban on the related and unfair practice of "flashing" orders on certain exchanges.

Interestingly, even as the Release was being crafted, several exchanges that had operated on a customer priority/size pro-rata market structure have partially adopted make/take pricing mechanisms. These decisions, made in a free-market economy by competitive businesses, demonstrate that assessing an increased access fee (in this case, imposing a higher “take” fee) does not discourage the accessing of quotations by an exchange’s internal customers. Instead, these exchanges have determined that growth in activity comes from encouraging a smaller spread between the bid and the offer. By allowing exchanges to set fees within general non-discriminatory guidelines, market forces overall will continue to compel the tightest, most competitive national market possible.

Sincerely,

Janet M Kissane