NASDAQ OMX

Joan C. Conley
Senior Vice President and Corporate Secretary

August 9, 2010

Ms. Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

RE: Elimination of Flash Order Exception from Rule 602 of Regulation NMS
File No. S7-21-09

Dear Ms. Murphy:

The NASDAQ OMX Group, Inc. ("NASDAQ OMX") welcomes the opportunity to submit comments in connection with the above-referenced proposal by the United States Securities and Exchange Commission ("SEC" or "Commission") to amend Rule 602 of Regulation NMS to eliminate the exception for the use of flash orders by equity and options exchanges. Recently, the SEC reopened the period for public comment on its proposal to eliminate the flash order exception with respect to listed options. As outlined in more detail below, NASDAQ OMX supports the elimination of flash orders as inconsistent with price discovery and fair and efficient markets.

NASDAQ OMX is the world's largest exchange company, operating 22 markets and ten clearinghouses world-wide as well as providing technology to over 70 exchanges, clearing organizations and central securities depositories in over 50 countries. We regulate the trading and clearing of equities, options, commodities, and derivatives across the globe. NASDAQ's two U.S. options markets, NASDAQ OMX PHLX ("PHLX") and The NASDAQ Options Market ("NOM") execute approximately 23% of options transactions daily.[1]

NASDAQ recognizes that there has been confusion about how flash orders function in both the equities and options markets and that flash orders are often mischaracterized. We agree with another commenter[2] that the options markets are very different from the equities markets in a number of ways and believe that CBOE's explanation of how their flash operates is important to understanding its intended benefits when taking exchange fees into account.

As we stated recently in response to the Concept Release on Equity Market Structure, fair and open access to trading systems and trading interest, reliable and liquid public reference

[1] NASDAQ OMX Group, Inc. files this comment on behalf of the two options markets it operates in the U.S., The NASDAQ Options Market LLC and NASDAQ OMX PHLX, Inc.

[2] *See* letter from William J. Brodsky, Chairman & CEO, Chicago Board Options Exchange, to Elizabeth M. Murphy, Secretary, Commission, dated November 18, 2009.

prices, and effective private linkages are each fundamental to a strong national market system.[3] Open access to the best displayed prices fosters order interaction, price discovery and market efficiency; restricted access creates order isolation, price opacity and inefficiency.[4] For these reasons, NASDAQ supports the elimination of electronic flash orders in both equities and options. With respect to equities, NASDAQ has been on the record as opposing flash for some time.[5] In fact, NASDAQ voluntarily withdrew its flash functionality rather than create even the appearance of unfairness in its market.[6]

With respect to options, NASDAQ takes this position based on several important market quality and investor protection principles that have been instructive in equities as well as options and should likewise guide the Commission in its ongoing analysis of flash order functionality. First, robust public price discovery is a critical element in creating fair and efficient markets in both cash equities and options. Any market structure or process that systematically removes the incentives of market participants to risk capital by publishing firm quotes establishing public prices transparent to all investors erodes market quality. Market centers that contribute public, firm quotes to the consolidated national market data feeds are the cornerstone of the U.S. financial system and in maintaining investor confidence that system. Second, fair and equal access to trading systems and available trading interest needs to be guaranteed. Stepping away from this principle and towards selective disclosure and special access to quotes or orders, creates a market where information is unnecessarily segmented and certain market participants may have unfair trading opportunities and informational advantages over average investors. Finally, the Commission should encourage innovation and competition. The liquidity and market benefits derived from advances in the speed and sophistication of electronic trading in the public market are manifest, and the Commission should take steps to ensure its final rules allow that important process to continue by not unduly inhibiting the ability or incentive of market participants to continue to invest and improve their trading systems.

Applying the above principles, it is clear that, in the interest of a strong national market system rooted in competition, flash orders should be eliminated from all market centers and trading mechanisms. Flash orders degrade the transparency and price-discovery functions that are at the heart of a true national market system. By elevating private information and access advantages above vigorous consolidated quote and order competition via the national best bid/offer, flash orders artificially limit and delay the dissemination of best-priced trading interest to the public market and the investors that market serves. The result is an environment where flash order recipients passively refrain from displaying their own willingness to buy and sell

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3 *See* Concept Release on Equity Market Structure (Release No. 34-61358; File No. S7-02-10). NASDAQ's comment letter is available at: http://www.sec.gov/comments/s7-02-10/s70210168.pdf.

4 NASDAQ commented similarly on the Proposed Amendments to Rule 610 of Regulation NMS with respect to the proposed options access fee cap ("Fee Proposal") (Release No. 34-61902; File No. S7-02-10). NASDAQ's comment letter is available at: http://www.sec.gov/comments/s7-02-10/s70210168.pdf.

5 Greifeld, Bob, Exchanges should unite to end flash orders, Financial Times, Op-Ed, August 6, 2009.

6 Id.

while at the same time retaining a superior opportunity to trade with orders before they are ultimately displayed to the public market. In such an environment, options market makers respond to orders rather than attract them. In turn, a smaller number of market participants taking part in the public price discovery process reduce the strength and vitality of the national best bid/offer. The inevitable result is a diminished incentive to quote in the public market and wider spreads. We believe that the incentive to provide a tight market is fundamental to the options marketplace.

Flash orders do not promote fair and equal access in the markets. Market centers utilizing flash orders are under no obligation to make them available for execution in the same manner as public quotes and are under no obligation to display flash orders to all investors. Hence, not all market participants may see, or attempt to trade with, flash orders until a much smaller group of market participants gets first shot at them[7] As such, flash orders can lead to selective information leakage and special execution opportunities that advantage those participants, a result that Regulation NMS and Regulation ATS were intended to prevent. In options, flashing an order that is otherwise executable on another market to a select group, whether market makers or members, is inappropriate and inconsistent with fair and equal access. We understand that delaying an electronic execution for a brief period is an alternative way to seek additional liquidity or a step-up before routing an order to another marketplace, and that the history of the step-up was to redistribute market makers' liquidity from across many markets and strike prices to where it is needed, while addressing the very real risk management issues of such market makers. Moreover, such a brief delay provides an opportunity for an exchange's own markets to update, without "flashing" or showing the order to a select group. PHLX's routing functionality currently provides such a brief delay, which would now be considered an impermissible flash.

Nevertheless, we believe that the options market as a whole would be better served if this type of flash were eliminated. For those seeking to avoid the routing delay, we offer a "do not route" functionality. At the same time, we recognize that there are certain types of functionality that are uniquely-tailored to certain types of orders or trading situations, where a true liquidity-seeking message is important. For example, PHLX's functionality, called Quote Exhaust and Market Exhaust, operates in the unusual circumstances where all quotes at a particular price level are depleted or both quotes and orders are depleted, respectively. In these specific situations, rather than execute at a far-away price, this functionality provides an opportunity for the market to reestablish itself, across exchanges. Accordingly, we believe that some functionality can provide investors and professionals alike with alternatives that do not create the unequal access and price discovery concerns that routing delays do.

While the above highlights the clear flaws of flash orders and the benefits of various other functionalities operating in the options markets, NASDAQ OMX also urges the Commission to be vigilant that processes similar to flash orders that likewise reduce the quality of the public market be carefully considered. As the Commission recognized in its flash order proposal, traditional auction processes play an important role in our trading markets. Nevertheless, flash order functionality is not appropriate simply because it is called an auction.

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[7] *See e.g.* Securities Exchange Act Release No. 61731 (March 18, 2010). A flash coupled with a flash rebate or credit further discourages incentives to quote.

The Commission also requested comment, in the original proposing release,[8] whether Rule 602 should permit trading floors to continue manual "flashing" of orders if electronic "flashing" is prohibited. We think the answer is yes and that a narrower regulatory approach is required, because deleting the exception in paragraph (a)(1)(i)(A) of Rule 602 is likely to impact floor trading in a way that seems unintended. In imposing a ban on flash orders, the Commission seems to have swept into its proposal the way that floor brokers do business on trading floors. NASDAQ is concerned that the elimination of paragraph (a)(1)(i)(A) of Rule 602 would require an exchange to collect bids and offers from floor brokers verbally representing orders on its trading floor. In options, floor brokers continue to constitute a vibrant part of the business. The orders handled by floor brokers often, but not always, involve larger size, negotiation and discretion.

Although the Commission has acknowledged that the history of this exception was based on manual trading and the need to accommodate the "ephemeral" nature of floor-based quotes, the Original Proposing Release quickly turns to defining the electronic flash. Manual trading still occurs on options trading floors and remains an important method of order entry and execution in today's markets. Banning electronic flash orders, which we support, will not put an end to electronic trading; however, the Commission's current approach in eliminating paragraph (a)(1)(i)(A) of Rule 602 might cripple manual trading, without a rigorous analysis of whether that is an appropriate outcome in today's national market system.

In the Release, the Commission has requested comment on the extent to which flash orders and access fees are linked. Specifically:

> Commenters argued that flash orders were necessary in the options markets to avoid the access fees that otherwise would be charged if the orders were routed to other exchanges. If the Commission adopted a cap on access fees for listed options, would the change remove the need for exchanges to use flash orders to prevent their customers from incurring high access fees? Would the reduction in benefits of flash orders for listed options go beyond the direct effect of the reduction in access fees, such as through an impact on spreads or order book liquidity? If so, how much weight should be given to this net reduction in benefits of flash orders in the Commission's analysis of the costs and benefits of the Proposal to eliminate the flash order exception for listed options?[9]

NASDAQ believes that the relationship between flash orders and access fees is artificial and pretextual. Order flashing is about adverse selection risk, not access fees. Flashing of orders has existed in non-electronic markets for many years, long before the maker/taker pricing model and long before the current iteration of access fees. Flashing allows firms to control their order and avoid the adverse selection risk created by offering a "free" limit order to the marketplace.

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[8] *See* Securities Exchange Act Release No. 60684 (September 18, 2009) (Elimination of Flash Order Exception from Rule 602 of Regulation NMS; File No. S7-21-09)("Original Proposing Release") at 28.

[9] *See* Securities Exchange Act Release No. 62445 (July 2, 2010) (Elimination of Flash Order Exception from Rule 602 of Regulation NMS; File No. S7-21-09) at 6.

Adverse selection risk or the risk of adverse price movements while a security is held in inventory is generally offset by the bid/ask spread that a market maker captures. By flashing orders rather than posting liquidity, firms avoid adverse selection risk and also widen the bid/ask spread resulting in greater compensation for market making.

The attacks on maker/taker pricing and the promotion of fee caps are simply attempts to reduce competition and control the costs of doing business. Market forces should determine exchange fees and the Commission should not be drawn in to price fixing. Given the proliferation of business models and exchanges as well as the concentration of market power in options order routing firms, there is no evidence to support the assertion that market forces do not or cannot constrain access fees. In response to the Fee Proposal, NASDAQ has clearly stated its fee on access fee caps and we seek to reiterate that view. In particular, NASDAQ believes that, if adopted, the Fee Proposal would undermine robust competition, harm investors, and weaken the national market system. To reiterate:

> Maker/Taker fees are substantially lower than the value of a standard trading increment (*e.g.* if the price is $0.01 better than the price on another exchange, this $0.01 is equivalent to $1.00 to the customer per contract traded). No data is provided to support the argument that access fees are restricting efficient access to quotations, that they have caused an increase in locked markets, or that a fee cap of $0.30 is the only or even best way to address such perceived problems. Competition is working; there is no evidence or analysis to the contrary.[10]

In closing, NASDAQ believes that flash orders degrade the transparency and price-discovery functions that are at the heart of a true national market system by diminishing the incentive to quote. NASDAQ OMX thanks the Commission for its leadership in moving quickly to address the important investor protection and market structure issues raised by flash orders. The Commission has chosen the right path by proposing their elimination, and we urge the Commission to continue to move to improve the fairness and integrity of our nation's securities markets.

Sincerely,

Joan C. Conley

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

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[10] *See* http://www.sec.gov/comments/s7-02-10/s70210168.pdf at 10.