

VIA EMAIL AND FEDERAL EXPRESS

August 9, 2010

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

Re: SEC Release No. 34-62445 – File No. S7-21-09

Dear Ms. Murphy:

NYSE Euronext, on behalf of its subsidiary options Exchanges, NYSE Arca Inc. (“NYSE Arca”) and NYSE Amex LLC (“NYSE Amex”), appreciates the opportunity to further comment on the Securities and Exchange Commission (“SEC” or “Commission”) proposed Elimination of Flash Order Exemption (“Proposal”)¹ from Rule 602 of Regulation NMS under the Securities Exchange Act of 1934,² with particular attention on listed options. NYSE Euronext continues to support the Commission’s Proposal to eliminate the exemption, and appreciates the opportunity to demonstrate the particularly pernicious nature of flash order mechanisms in the options industry. We believe additional comments on the elimination of flash order mechanisms, as they pertain to the U.S. listed options marketplace, are strongly warranted.

Our earlier comments on the Commission’s Proposal focused on issues relating to the cash equities markets.³ As we stated in the original comment letter, we believe the aspects of flash trading that are seen as troubling in the context of the equities markets, namely the disincentive to post limit orders, the creation of private, locked markets that are neither transparent nor fair, and the anti-competitive impact of the practice apply equally to the options marketplace. Arguments to the contrary, such as the potential for options flash order mechanisms to provide price improvement or cost savings, are misleading and must be

¹ See Securities Exchange Act Release No. 60684 (September 18, 2009), 74 FR 48632 (September 23, 2009).

² 17 CFR 242.604.

³ See letter dated November 23, 2009 from Janet Kissane, Senior Vice President, Legal and Corporate Secretary, NYSE Euronext. In particular, as noted in that letter, NYSE Euronext supports eliminating flash orders, but believes that the Commission’s proposal to delete Rule 602(a)(1)(a) is unnecessarily broad and may result in banning long-standing and appropriate trading practices.



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viewed in light of all potential outcomes, both positive and negative, associated with flash order mechanisms.

Unlike the cash markets, the listed options market is extremely transparent and this transparency has been a key factor in its strong, consistent and continued growth. While the industry supports various market structures and trade allocation schemes, the overall framework of the options market incorporates certain long standing principles: limited guaranteed allocations for principals, exposure of customer interest before crossing, and representation of trading interest in the disseminated market to maintain priority. Continuation of flash mechanisms will move the U.S. markets away from a robust price discovery structure towards a more fragmented, European style market characterized by off-exchange negotiation.

I. Background

Flashed orders are orders which are marketable against the NBBO but not against the best bid or offer (“BBO”) on the exchange upon which the order was entered. When an options market receives such a marketable order, it exposes the order – or flashes it – to other participants on that exchange for a period of time in hopes of finding contra interest willing to trade with the order at the NBBO. If the flashed order is not filled during the flash period, in whole or in part, any unexecuted portion is routed to the market(s) at the NBBO.

Flash mechanisms grew out of the order handling practices in use at the time of the introduction of the Intermarket Linkage in February 2003. At that time only one option exchange was fully electronic, and all of the exchanges had principals who were appointed to have agency responsibility for the handling of customer orders. Each order that was not automatically executed was reviewed and a determination was made to execute or route away to the NBBO. Principals who handled such orders were governed by rules that prohibited trading based on knowledge of the order. The current rules for flashing option orders date back to this era, when the Intermarket Linkage was inefficient and the receiving exchange had up to twenty seconds to report a fill or cancel of a linked order.

The evolution of market structures has migrated away from a model where the principal has an agency responsibility to where exchange systems electronically accept and process customer orders more efficiently and on a neutral basis. As market technology has improved, some exchanges automated the routing decision so as not to impede reaching the NBBO for routable orders. With that efficiency, some market participants lost the advantage of seeing the order before it was routed. They could no longer lie in the weeds until an attractive order was exposed. Thus, some markets adopted rules to expose a customer order for a brief period before routing to the NBBO market, i.e., the flash order mechanisms.



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While routing over the Intermarket Linkage was originally structured with a turnaround time of up to 20 seconds, today, with highly efficient electronic systems, the one second flash period is much longer than the time it takes to route an order to the NBBO and get a response. For example, NYSE routing fill and cancel reports are in the 200 – 300 millisecond range. The same improvements in market technology that have benefited customer orders have been adopted by market professionals such that they can receive, process, and respond to an order being exposed within milliseconds. However, that efficiency should not be used to the disadvantage of a customer.

“Flash orders” as a specific order type, such as a limit or market order, do not actually exist within the options marketplaces. Rather, a flashing mechanism is *involuntary and automatic* from the customer’s perspective, in that the customer cannot choose to “opt in” or “opt out” of a flash. While order handling rules generally require that a specific instruction be indicated by the customer, no such instructions are available for a customer to direct a broker or an exchange to flash an order, or, for that matter, not flash an order. The only way for a customer to effectively “opt out” of a flash is by including an execution qualifier that precludes flashing of the order, such as Immediate-or-Cancel (“IOC”), Fill-or-Kill (“FOK”) or All-or-None (“AON”). Unfortunately, use of these instructions to avoid having one’s order flashed means that the customer may also miss being filled at the National Best Bid or Offer (“NBBO”), as the order may not be routed to an away market with the best price.

II. Flashed Orders in the Options Markets Harm Customers’ Interests.

Some have argued that flash order mechanisms should not be eliminated from the options markets due to the unique nature of those markets. We disagree with this assessment. The backbone of the options markets is constituted of robust, deep pools of liquidity that are transparent, extremely competitive, and accessible to all participants. In the options markets, just as in the equities markets, customers’ interests are harmed when a market center electronically flashes to its market participants, where no fiduciary duty exists, a marketable non-contingent order that did not require any type of negotiation to execute, simply to avoid trading at an away exchange that is already displaying the NBBO. Allowing flash order mechanisms to continue in the listed options markets will harm investors by giving privileged traders unequal access to pricing information while potentially raising the costs to the rest of the marketplace, since the mechanism enables a select group to participate on a trade without first providing the most competitive quote. In this way, adoption of flash mechanisms on exchanges works to the detriment of the quality of the markets. Knowing a marketable order will be flashed encourages market participants to provide less aggressive markets and instead get a preview of risk versus opportunity prior to making the decision to trade, ignore, or take advantage of the information presented by the flash.



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Because of the price discovery nature of the options marketplace, an order communicates more than just demand for the contract; it may also indicate a potential for a change in the price of the underlying security. As an option on an equity trades, the contra side will move to hedge the transaction by buying or selling stock as quickly as possible. When an options participant receives the flash notification, that participant has no agency responsibility to the order, yet has a unique, and perhaps unfair opportunity to use this exclusive information to either trade in the underlying, adjust their option prices in anticipation of the hedge moving the underlying security, or trade with the option NBBO interest ahead of the flashed order. Moreover, the flashed order is displayed to a limited number of participants. In other words, flashed orders result in a two-tiered market providing an advantaged group of participants, without any fiduciary responsibility to the order, with valuable information that may be used to make trading decisions against the interests of other investors, including trading ahead of public customers.

Flashing mechanisms are not the only solution available to exchanges that wish to provide their participants with the ability to match the NBBO. For example, on both NYSE Arca and NYSE Amex options markets, certain order types have the ability to offer additional guaranteed liquidity at the NBBO price and additionally facilitate retention of the execution at that trading venue. These order types do not provide any market participants with an advance look at an order or trading interest. Rather, the functions are automatic and based on pre-determined sources of liquidity that the market participant is willing to provide. Furthermore, these order types do not carry the risks, as do flashed orders, that the customer will not receive a fill of their order, or if they do, that they will be filled at an inferior price.

III. Flashing should be Prohibited Irrespective of whether a Fee Cap is Enacted.

Some arguments in support of flash trading in the options markets state that the practice saves customers money by potentially avoiding the need to route to better priced markets that charge “taker” fees. NYSE Euronext strongly believes that, in the context of the options markets, the concepts of flashing mechanisms and the fees that exchanges are able to charge, and potential caps on those fees, are completely separate and independent of each other. Commission consideration of these concepts, to the extent they are not already, should be bifurcated and analyzed irrespective of each other. The results of Commission action on these two concepts, if any is taken, will have significant impacts in the options marketplace, and for that reason, each should be measured completely on its own merits. Any approach whereby flashing and fee caps are considered in tandem risks valuing the attributes of one, whether positive or negative for the options markets and investors, too greatly and at the expense of the other.



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However, if the Commission is considering these two concepts as, at the very least, touching upon each other, or to a larger extent, as impacting each other directly, then simply put, and as stated in a letter to the Commission regarding a proposed rule to establish a limit on access fees that an exchange would be permitted to charge for access to its best bid and offer for listed options on its exchange “...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.”⁴

The argument that flashed orders provide potential cost savings for options customers due to “taker” fees deserves scrutiny. It is true that, where multiple exchanges are all bidding or offering at the same price, a customer who sends an order to an exchange such as NYSE Arca options that charges “taker” fees⁵ may, or may not, incur a greater cost than if the order executed on an exchange that does not charge such fees for execution. However, the opportunity costs to customers often far exceed these potential fee premiums when certain market participants receive exclusive, flashed information about an order. When a marketable order is held up for exposure using a flash mechanism, instead of immediately routing to a better priced market, this delay may cause the NBBO to move against the customer’s interest, missing the better priced market. The following example illustrates this point.

NYSE Arca’s “taker” fees are \$0.45 per contract as compared to the minimum price variations of \$0.01 for options under \$3.00 and \$0.05 for options over \$3.00 that are part of the Penny Pilot. Since option premiums typically have a multiplier of \$100, in the context of minimum price variations a \$0.01 change in the option price translates to \$1.00 in value gained or lost and a \$0.05 change in the option price translates into \$5.00 in value gained or lost.

⁴ See Letter dated June 18, 2010 from Janet M. Kissane, Senior Vice President, Legal and Corporate Secretary, NYSE Euronext, commenting on SEC Release No. 34-61902.

⁵ At the time of this letter, six of the eight option exchanges have adopted “maker/taker” pricing models in whole or in part.



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<u>Exchange</u>	<u>Bid Size</u>	<u>Bid Price</u>	<u>Ask Price</u>	<u>Ask Size</u>
NYSE Arca	100	\$3.00	\$3.05	10
Exchange A	100	\$3.00	\$3.10	100
NBBO	200	\$3.00	\$3.05	10

Exchange A receives a customer market order to buy 10. That exchange “flash” exposes the order to its market participants. Due to the flash period, 500 milliseconds go by and another customer order arrives at NYSE Arca that takes the 10 contracts offered at \$3.05. The new NBBO is now \$3.00 x \$3.10, 200 up. The one second flash period at Exchange A ends with the customer getting filled at the new NBBO of \$3.10—a full \$0.05 worse than the NBBO when the marketable order was received. In this example, the delay in routing the order immediately to the better priced market cost the customer \$45.50 (\$50.00 – \$4.50 in “taker” fees). Accordingly, to suggest that by offering a flash order mechanism exchanges are saving customers money is misleading because the potential exists for the opportunity costs of missed executions/prices to far exceed any real costs associated with “taker” fees.

Although we strongly believe that flash mechanisms and exchange fees should not be considered as part of the same analysis this example illustrates that, if considered together, the argument that flash mechanisms are needed to offset “taker” fees on away exchanges is rendered completely obsolete, as all exchanges will be charging inherently “fair” fees.

IV. Flashing is not Price Improvement and Provides no Guaranteed Fill.

Some have argued that allowing flash mechanisms fosters “price improvement.” However, it is critical to recognize that a flashing mechanism differs from an automated price improvement auction in a fundamental way in the listed options markets. Most importantly, a price improvement auction guarantees a matching execution at the NBBO while attempting, and in many cases, achieving a better price for the order over the NBBO. Flashing, on the other hand, results in only the possibility of matching the existing NBBO price, without a guarantee thereof, only the possibility of bettering the NBBO price, or simply not filling the marketable order and routing it after the flash period has expired. This distinction is particularly troubling in those instances where, during the flash period, the NBBO actually moves against the customer’s interests. When this occurs, the customer is in no way



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guaranteed to receive the initial NBBO price. This outcome stands in sharp contrast to price improvement auctions where the customer is protected and guaranteed an execution stopped at a price equal to or better than the NBBO at the commencement of the auction. Flashed orders, conversely, provide participants with unequal access to valuable information, no obligation to trade, and no assurance that a marketable order will receive a fill at the NBBO price that existed when the order was received.

When shown in this light the flash mechanisms can not be considered in the same category as price improvement mechanisms as a useful tool whereby investors receive better prices. In fact, we believe that flashing may often result in the opposite—price *dis*-improvement as compared to the NBBO at the time a flashing exchange receives the order.

V. Conclusion

NYSE Euronext applauds the Commission's request for additional comments on the Proposal so that use of flash mechanisms in the options industry can be further explored, and, eventually eliminated. We continue to believe that flash mechanisms are detrimental to the industry, independent of any other market structure issues, such as potential caps on exchange fees.

We appreciate the opportunity to provide additional comment on this important Proposal. For the reasons stated above, we urge the Commission to include the options markets within its Proposal to eliminate the flashed order exemption from Rule 602 of Regulation NMS, and any potential final approval thereof, and to proceed with eliminating flashed orders from the regulated securities markets entirely.

Very truly yours,

A handwritten signature in black ink, appearing to read "Janet McKissack". The signature is written in a cursive style with a large initial "J".