SIFMA

Securities Industry and Financial Markets Association

BY EMAIL TO: rule-comments@sec.gov

August 10, 2010

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

Re: File Number S7-21-09

Dear Ms. Murphy:

The Equity Options Trading Committee ("Committee") of the Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to provide the Securities and Exchange Commission (the "Commission") with our comments regarding the Commission's proposal to eliminate the flash order exception provided in Rule 602(a)(1)(i)(A) of Regulation NMS (the "Proposal").[2] The Committee is responding to the Commission's recent release requesting additional information and comment as to whether flash orders should be banned in the listed options markets (the "Release").[3]

The Committee submitted its comment on the Commission's original Proposal to ban flash orders in a letter dated December 1, 2009 (the "December Letter"). The Committee continues to believe, as stated in that letter, that flash orders are beneficial to options investors, especially retail options investors. We believe that a broad ban on flash orders would not only deprive investors who use them of those benefits, but we also believe that such a ban could have significant adverse consequences for the options markets generally by decreasing competition and liquidity and increasing volatility. We have set forth our reasons for this belief in the course of responding to the specific questions posed in the Release. Various questions posed by the Commission in the Release requested data that is more readily, or in some cases exclusively, available from the options exchanges. Accordingly, with respect to requests for data, the Committee will rely on the options exchanges.

---

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to develop policies and practices which strengthen financial markets and which encourage capital availability, job creation and economic growth while building trust and confidence in the financial industry. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("GFMA"). For more information, visit www.sifma.org.

[2] Release No. 34-60684 (September 23, 2009).

[3] Release No. 34-62445 (July 9, 2010).

Structural Differences between the Options Markets and the Equities Markets Affect the Relative Benefits of Flash Orders in the Options Markets

As stated in our December Letter, important structural differences exist between the equity markets and options markets. Moreover, equity markets and options markets satisfy the obligations set forth under the Commission's Regulation NMS in different ways, and not all of the Regulation NMS provisions apply to the options markets. Option market-makers do not have the ability to "layer quotes" (*i.e.*, quote multiple price levels for the same series) and must quote in multiple series. These challenges reduce the depth of options markets as compared to equity markets and greatly increase the need for market structures that enhance liquidity. The fact that options must be quoted in multiple series enhances the need for market structures that foster liquidity.

The Committee estimates that approximately 90% of the trading volume in the equities markets takes place on exchanges that are based on the "maker-taker model" under which orders taking liquidity are typically charged a fee, and resting orders that provide liquidity and establish the national best bid or offer ("NBBO") may earn a fee. In sharp contrast, approximately 70% of the trading volume in the options markets is on exchanges that follow a "traditional model" in which routing fees charged by the destination market are absorbed by the market transmitting the order, and market participants have the capability to "step-up" to execute orders at prices equal or superior to the NBBO before orders are routed away. The remaining 30% of the volume takes place on options markets that charge maker-taker fees. Whatever the merits of a flash order ban in the equity markets, we believe that imposing such a ban in the options markets would be to disregard the important differences in the structure of these markets.

A Ban on Flash Orders Would Push Options Market Structure toward the Maker-Taker Model with Adverse Consequences for Depth and Liquidity of Markets

The quality of markets must be judged not only by the narrowness of spreads, but also by the liquidity that is produced. The size of quotations must be considered as well as price in determining the quality of quotations available on a market. As noted above, liquidity is a particularly important issue in the options markets. Market-makers on traditional exchanges typically quote in larger size than do liquidity providers on the maker-taker exchanges. Market-makers at traditional exchanges quote aggressively not only in terms of price, but also in terms of size because opportunities for execution are allocated based upon quotation size. Quoting in size, however, increases the risk to the market-maker of losses resulting from having quotes opportunistically accessed by sophisticated traders who may have superior information or take advantage of the momentary lags in a market-maker's ability to update quotes to reflect new information that the market-maker receives. The Committee believes that a ban on flash orders would reduce the incentive of market makers on traditional exchanges to quote in size because that alternative means of executing smaller orders at a better price would be blocked. Additionally, the Committee is concerned that such a ban could push the options markets toward greater dominance of the maker-taker model. The decline of the traditional model would have two detrimental effects on retail customers – the information that markets rely on to attract orders will diminish, and execution costs will increase due to reduced depth and wider quotes.

The Committee stresses the critical fact that market-makers at traditional exchanges are subject to *rigorous and enforceable obligations to make continuous and competitive two-sided markets*. The affirmative obligations of market-makers in those markets greatly enhance the likelihood that there will be liquidity in those markets when market conditions are adverse. The Committee is particularly concerned that an options market structure that becomes too heavily dominated by a maker-taker model will increase the vulnerability of markets to another "flash crash" similar to that which occurred in the equity markets on May 6 of this year. More specifically, because maker-taker quotes are generally much smaller than the quotes emanating from the traditional markets, a migration to the maker-taker model raises the concern that the options markets would become less liquid in general. Accordingly, the proposal to eliminate flash orders appears to be counter to the current focus on reducing liquidity gaps in pricing at and around the NBBO.

The Commission itself has previously noted that "…the flash mechanism may attract additional liquidity from market participants who would not be willing to display their trading interest publicly." This may in fact allow for better execution than re-routing such trading interest elsewhere with no guarantee that the re-routed orders would obtain an execution.[4]

Flash Orders Do Not Destroy Incentives to Quote Aggressively

The fact that market-makers are willing to "step up" to execute a customer's order that is flashed at a price better than the market-maker's quote at the time should not be interpreted as an indication that market-makers are not displaying their best prices or that flash orders discourage market-makers from displaying their best prices. The comparison is of apples to oranges. Exchanges provide economic incentives to liquidity providers to step up to a flash order by waiving transaction and marketing fees and, in some cases, providing rebates. A market-maker's willingness to "step up" to a flashed order reflects these incentives, and the fact that the market-maker knows the size of the order means the market-maker can therefore ascertain more precisely the risk that execution of the order presents. It does not follow that, if flash orders were banned, market-makers would be encouraged to quote better prices in the same size.

During the time that flash orders have been available in the options markets, there has been exponential growth of the options markets which has consequently increased quoting activity. Options exchanges deploying maker-taker markets have continued to compete successfully with exchanges permitting flash orders. Given that the Commission estimated that flash volume accounted for approximately 2% of the average daily volume in listed options,[5] it is difficult to see how flash orders could pose a significant disincentive to quoting activity. It is not a viable strategy for a market-maker to withhold his or her best

[4] Release No. 34-60684 (September 23, 2009) at 48637.
[5] *See id.* at 48643.

quotations in the expectation of obtaining executions through flash orders that constitute only 2% of the market.

Flash Orders Improve Execution for Customers Who Use Them

In instances in which the away quote size meets or exceeds the size of the incoming order, flashed orders are filled through the "step up" procedure more than 60% of the time. In addition, the liquidity enhancement provided by step-ups is significant. For example, when a public customer order to buy 30 contracts is placed on a traditional market and the maker-taker market away is displaying an order for five contracts at a price one penny better, the step-up generally includes filling the public customer on the entire order as opposed to just the five contracts that would be received if the order were rerouted to the away market. Brokers have the choice of whether or not to use the flash process, and they do so when they believe it to be in their customer's best interest.

Flashed Orders That Are Routed Away Rarely Miss the NBBO Market, and Brokers Typically Honor NBBO in Such Instances

In question 5 of the Release, the Commission asked whether commenters agree with the statements that flash orders that are routed away rarely miss the NBBO market and that in such instances, brokers typically honor NBBO for their customers. The Committee agrees with both of these statements. Brokers typically honor NBBO when a flash order is routed away because brokers that do not provide NBBO are forced out of the options market by competitive forces, including competition for best execution. Furthermore, options exchanges have trade-through prevention and distributive linkages which virtually guarantee execution at or better than the NBBO. Exception reports widely used by brokers and by some exchanges to determine execution quality identify trades that are executed outside the NBBO at the time an order is received. In light of this, the Committee notes that the NBBO honored when flashed orders miss the NBBO market is based on the NBBO at the time that the order is received at the flashing exchange.

Traditional Exchange Participants, Rather than Maker-Taker Exchange Participants, Set Options Market Prices

In the Release, in question 7, the Commission distinguishes between "aggressive" quotations that are price leaders and narrow the NBBO and "matching" quotations that only follow the NBBO. The Commission asks whether market-makers on traditional exchanges quote aggressively in this sense and whether banning flash orders would increase aggressive quoting on one or both types of exchanges.

In considering the Commission's question, it is important to consider the significant structural differences between equity and options markets. The options market is fundamentally quote driven and the equities market is order driven. Markets at maker-taker exchanges are derived primarily from orders entered based on information gathered from firms that are participants on traditional exchanges and that have invested their capital, both intellectual and monetary, to calculate value and risk associated with pricing options.

Specifically, participants on traditional options exchanges, where the most active participants are professional liquidity providers,[6] set pricing and volatility curves for all options series by virtue of the thousands of quotations they provide. Participants on maker-taker exchanges for the most part are simply reacting to these quotations rather than acting as true price setters. They tend to post quotes that improve prices by a *de minimis* amount that is further reduced or eliminated when an adjustment is made to account for the effect of access fees. A ban on flash orders, regardless of whether the exchange provides "aggressive" or "matching" quotations, would *reduce*, not increase, competition and incentives for aggressive quoting, even if the Commission were to impose a cap on access fees. As previously noted, the Committee believes that a ban on flash orders would push the options markets more toward a maker-taker model, and that this would curtail competition and incentives for aggressive quoting.

The Maker-Taker Exchanges Do Not Foster More Aggressive Quoting

In question 6, the Commission asks whether liquidity rebates are the sole reason that liquidity providers on maker-taker exchanges are willing to quote aggressively. The Committee disagrees with the premise of the question. It is clear to the Committee that maker-taker exchanges do not quote aggressively once quotes are adjusted to account for the access fee paid. Further, the Committee disagrees that liquidity providers at maker-taker exchanges quote more aggressively in the class of options in which they are active even if access fees paid are *not* taken into account. Although they may improve quotes by a *de minimis* amount in a few selected series, they typically provide little or no liquidity in other series. Aggressive quoting and the quality of a market cannot be fairly assessed without taking into consideration size as well as price. As noted above, the method of allocation of executions on traditional options exchanges provides incentives for market-makers to quote in size with the result that the markets on traditional exchanges provide greater depth and price stability. A market structure that moves predominantly or exclusively to a maker-taker model will exacerbate the tendency toward greater market volatility and liquidity vacuums.

Order Execution Quality Statistics Are Publicly Available, and Broker-Dealers Must Ensure Customers' Order Execution Quality Without Regard to Payment for Order Flow

We disagree with the Commission's assumption reflected in questions 3 and 10 of the Release that there is no publicly available order execution quality data. There is a host of order execution quality statistics that are publicly available from various exchanges. Moreover, any lack of data does not eliminate executing agents' responsibility to provide customers with best execution by regularly and rigorously assessing order execution quality. Order execution quality is the responsibility of the broker-dealer handling the order as well as the broker-dealer placing the order.

In response to the Commission's query in question 8 of the Release as to whether flash orders at payment for order flow options exchanges play a significant role in allowing

[6] *See* letter submitted by CBOE in File No. S7-21-09 (November 18, 2009), p. 1.

such exchanges to compete for order flow through broker payments rather than by offering better prices to execute investor orders, it should be noted that all agents for customer orders have best execution obligations and payment for order flow does not prevent these agents from fulfilling this obligation.

Flash Orders Foster Competition without
Suppressing Other Price Improvement Mechanisms

We believe that the competition between the traditional model and the maker-taker model enhances the competitiveness of the options markets. Options markets have the flexibility to adjust their rules to appeal to a particular segment of the market or to reflect reasonable differences of opinion about the balance of costs and benefits of a particular structure. In response to question 9 of the Release, we believe that this flexibility is needed and would be diminished by a flash order ban. The Commission asked, also in question 9, whether the percentage of order flow in listed options that participates in price improvement mechanisms (such as PIP, PIM and AIM) offered by exchanges was less than 1%. Although exchanges can provide more precise data, the Committee believes that the percentage is significantly larger than 1%, and notes that usage of such price improvement mechanisms continues to grow and that such mechanisms are becoming a more important part of the options market structure. This trend has developed concurrently with the use of flash orders, and there is no reason to expect that it will not continue if flash orders continue to be permitted. For these reasons and for the other reasons stated herein, the Committee believes that a flash order ban will reduce rather than increase the competitiveness and efficiency of the options markets and therefore the quality of execution of customer orders.

Cap on Access Fees Would Not Remove Need for Flash Orders

In response to the Commission's first question in the Release, the Committee strongly believes that a cap on access fees would not remove the need for flash orders. Even capped fees would result in aggregate costs to investors, who would no longer have the alternative of obtaining price improvement through flash orders. More importantly, fee caps would do nothing to prevent the loss of market depth in the options market that would likely result from a ban on flash orders. The costs associated with this loss of depth would be far larger than any savings from a cap on access fees.

We believe that the Commission should also take into consideration the routing fees that the Committee anticipates would be imposed even if access fees were capped. The Committee is concerned that a cap on access fees would result in an increase in routing fees, which are not subject to a cap, thus significantly increasing costs and reducing investors' opportunity to receive the price improvement that flash orders currently provide. It seems evident to us that it is the net or "all in" cost of a transaction that is the relevant figure in assessing the quality of an execution. Moreover, because options prices are derived from the prices of underlying assets, increased routing fees would impair the usefulness of pricing formulas used to determine options prices, given that transaction costs and routing fees are not taken into account in such pricing formulas.

Summary and Conclusion

As the Commission has acknowledged, flash orders have clear beneficial effects in the markets.[7] For the reasons discussed above, the Committee believes that flash orders serve a particularly beneficial function in the options markets and are specifically useful in the context of markets following the traditional model rather than the maker-taker model. Flash orders can and often do provide price improvement to the Customers who use them, and rarely result in orders being executed at a price that is inferior to the NBBO at the time the order was received. As the Committee emphasized in December Letter, an investor's use of flash orders is voluntary, and investors are free to determine not to use flash orders if they believe flash orders will harm them. Competition among market models is beneficial to the options market as a whole and provides users of the markets with the opportunity to execute in the market environment that is most suited to their particular needs. The traditional exchanges provide price leadership, liquidity and market depth beyond that offered by the maker-taker exchanges, and these functions would be adversely affected by a flash order ban. An outright ban on flash orders overlooks the significant differences in the market structure of the options and equities markets, and would have the negative effect of encouraging a shift towards a maker-taker model market structure where the rigorous market-making obligations that exist in the traditional options markets are generally not imposed. We believe such a shift toward the maker-taker model would contribute to market volatility and lack of liquidity in adverse market conditions.

The Committee believes that the advantages of flash orders, including increased competition and aggressive quoting, outweigh any of the alleged negative effects of flash orders. The Committee does not believe that the existence of flash orders discourages competitive and aggressive quoting on the traditional options exchange, particularly when quotation size is taken into consideration. To the extent that flash orders might be used as a means of front running or engaging in other manipulative or abusive practices, the Committee supports measures to identify and curtail any such negative effects or abuses that may result from the use of flash orders. Targeted surveillance programs and other regulatory actions are more appropriate means to prevent abusive behavior than imposing an outright ban on flash orders that would not only deprive investors of the many benefits of flash orders, but likely would have unintended adverse consequences on the markets and investors, including an increased risk of significant liquidity gaps and increased price volatility. Indeed, because there is an electronic audit trail of the orders that are flashed and the market participants that are routing orders in the same options at or around the same time, the surveillance process for this type of activity should be very robust.

For the reasons stated above, the Committee respectfully requests that the Commission not eliminate the flash order exception with respect to the options markets. We thank you for the additional opportunity to comment on the Proposal and for your consideration of these views. If you have any questions, please do not hesitate to call me at 212-313-1260.

---

[7] Release No. 34-60684 (September 23, 2009) at 48637.

Sincerely,

Thomas F. Price
Managing Director
SIFMA

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Luis A. Aguilar, Commissioner
The Honorable Kathleen Casey, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Elisse B. Walter, Commissioner
Robert W. Cook, Division of Trading and Markets
James A. Brigagliano, Division of Trading and Markets
Daniel Gallagher, Division of Trading and Markets
Heather Seidel, Division of Trading and Markets
David Shillman, Division of Trading and Markets
Daniel Gray, Division of Trading and Markets
Steve Williams, Division of Trading and Markets
Theodore S. Venuti, Division of Trading and Markets

![SIFMA Securities Industry and Financial Markets Association]

BY EMAIL TO: rule-comments@sec.gov

August 10, 2010

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

Re: File Number S7-21-09

Dear Ms. Murphy:

The Equity Options Trading Committee ("Committee") of the Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to provide the Securities and Exchange Commission (the "Commission") with our comments regarding the Commission's proposal to eliminate the flash order exception provided in Rule 602(a)(1)(i)(A) of Regulation NMS (the "Proposal").[2] The Committee is responding to the Commission's recent release requesting additional information and comment as to whether flash orders should be banned in the listed options markets (the "Release").[3]

The Committee submitted its comment on the Commission's original Proposal to ban flash orders in a letter dated December 1, 2009 (the "December Letter"). The Committee continues to believe, as stated in that letter, that flash orders are beneficial to options investors, especially retail options investors. We believe that a broad ban on flash orders would not only deprive investors who use them of those benefits, but we also believe that such a ban could have significant adverse consequences for the options markets generally by decreasing competition and liquidity and increasing volatility. We have set forth our reasons for this belief in the course of responding to the specific questions posed in the Release. Various questions posed by the Commission in the Release requested data that is more readily, or in some cases exclusively, available from the options exchanges. Accordingly, with respect to requests for data, the Committee will rely on the options exchanges.

---

1 SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to develop policies and practices which strengthen financial markets and which encourage capital availability, job creation and economic growth while building trust and confidence in the financial industry. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("GFMA"). For more information, visit www.sifma.org.
2 Release No. 34-60684 (September 23, 2009).
3 Release No. 34-62445 (July 9, 2010).

Structural Differences between the Options Markets and the Equities Markets Affect the Relative Benefits of Flash Orders in the Options Markets

As stated in our December Letter, important structural differences exist between the equity markets and options markets. Moreover, equity markets and options markets satisfy the obligations set forth under the Commission's Regulation NMS in different ways, and not all of the Regulation NMS provisions apply to the options markets. Option market-makers do not have the ability to "layer quotes" (*i.e.*, quote multiple price levels for the same series) and must quote in multiple series. These challenges reduce the depth of options markets as compared to equity markets and greatly increase the need for market structures that enhance liquidity. The fact that options must be quoted in multiple series enhances the need for market structures that foster liquidity.

The Committee estimates that approximately 90% of the trading volume in the equities markets takes place on exchanges that are based on the "maker-taker model" under which orders taking liquidity are typically charged a fee, and resting orders that provide liquidity and establish the national best bid or offer ("NBBO") may earn a fee. In sharp contrast, approximately 70% of the trading volume in the options markets is on exchanges that follow a "traditional model" in which routing fees charged by the destination market are absorbed by the market transmitting the order, and market participants have the capability to "step-up" to execute orders at prices equal or superior to the NBBO before orders are routed away. The remaining 30% of the volume takes place on options markets that charge maker-taker fees. Whatever the merits of a flash order ban in the equity markets, we believe that imposing such a ban in the options markets would be to disregard the important differences in the structure of these markets.

A Ban on Flash Orders Would Push Options Market Structure toward the Maker-Taker Model with Adverse Consequences for Depth and Liquidity of Markets

The quality of markets must be judged not only by the narrowness of spreads, but also by the liquidity that is produced. The size of quotations must be considered as well as price in determining the quality of quotations available on a market. As noted above, liquidity is a particularly important issue in the options markets. Market-makers on traditional exchanges typically quote in larger size than do liquidity providers on the maker-taker exchanges. Market-makers at traditional exchanges quote aggressively not only in terms of price, but also in terms of size because opportunities for execution are allocated based upon quotation size. Quoting in size, however, increases the risk to the market-maker of losses resulting from having quotes opportunistically accessed by sophisticated traders who may have superior information or take advantage of the momentary lags in a market-maker's ability to update quotes to reflect new information that the market-maker receives. The Committee believes that a ban on flash orders would reduce the incentive of market makers on traditional exchanges to quote in size because that alternative means of executing smaller orders at a better price would be blocked. Additionally, the Committee is concerned that such a ban could push the options markets toward greater dominance of the maker-taker model. The decline of the traditional model would have two detrimental effects on retail customers – the information that markets rely on to attract orders will diminish, and execution costs will increase due to reduced depth and wider quotes.

The Committee stresses the critical fact that market-makers at traditional exchanges are subject to *rigorous and enforceable obligations to make continuous and competitive two-sided markets*. The affirmative obligations of market-makers in those markets greatly enhance the likelihood that there will be liquidity in those markets when market conditions are adverse. The Committee is particularly concerned that an options market structure that becomes too heavily dominated by a maker-taker model will increase the vulnerability of markets to another "flash crash" similar to that which occurred in the equity markets on May 6 of this year. More specifically, because maker-taker quotes are generally much smaller than the quotes emanating from the traditional markets, a migration to the maker-taker model raises the concern that the options markets would become less liquid in general. Accordingly, the proposal to eliminate flash orders appears to be counter to the current focus on reducing liquidity gaps in pricing at and around the NBBO.

The Commission itself has previously noted that "…the flash mechanism may attract additional liquidity from market participants who would not be willing to display their trading interest publicly." This may in fact allow for better execution than re-routing such trading interest elsewhere with no guarantee that the re-routed orders would obtain an execution.[4]

<u>Flash Orders Do Not Destroy Incentives to Quote Aggressively</u>

The fact that market-makers are willing to "step up" to execute a customer's order that is flashed at a price better than the market-maker's quote at the time should not be interpreted as an indication that market-makers are not displaying their best prices or that flash orders discourage market-makers from displaying their best prices. The comparison is of apples to oranges. Exchanges provide economic incentives to liquidity providers to step up to a flash order by waiving transaction and marketing fees and, in some cases, providing rebates. A market-maker's willingness to "step up" to a flashed order reflects these incentives, and the fact that the market-maker knows the size of the order means the market-maker can therefore ascertain more precisely the risk that execution of the order presents. It does not follow that, if flash orders were banned, market-makers would be encouraged to quote better prices in the same size.

During the time that flash orders have been available in the options markets, there has been exponential growth of the options markets which has consequently increased quoting activity. Options exchanges deploying maker-taker markets have continued to compete successfully with exchanges permitting flash orders. Given that the Commission estimated that flash volume accounted for approximately 2% of the average daily volume in listed options,[5] it is difficult to see how flash orders could pose a significant disincentive to quoting activity. It is not a viable strategy for a market-maker to withhold his or her best

---

[4] Release No. 34-60684 (September 23, 2009) at 48637.
[5] *See id.* at 48643.

quotations in the expectation of obtaining executions through flash orders that constitute only 2% of the market.

<u>Flash Orders Improve Execution for Customers Who Use Them</u>

In instances in which the away quote size meets or exceeds the size of the incoming order, flashed orders are filled through the "step up" procedure more than 60% of the time. In addition, the liquidity enhancement provided by step-ups is significant. For example, when a public customer order to buy 30 contracts is placed on a traditional market and the maker-taker market away is displaying an order for five contracts at a price one penny better, the step-up generally includes filling the public customer on the entire order as opposed to just the five contracts that would be received if the order were rerouted to the away market. Brokers have the choice of whether or not to use the flash process, and they do so when they believe it to be in their customer's best interest.

Flashed Orders That Are Routed Away Rarely Miss the NBBO <u>Market, and Brokers Typically Honor NBBO in Such Instances</u>

In question 5 of the Release, the Commission asked whether commenters agree with the statements that flash orders that are routed away rarely miss the NBBO market and that in such instances, brokers typically honor NBBO for their customers. The Committee agrees with both of these statements. Brokers typically honor NBBO when a flash order is routed away because brokers that do not provide NBBO are forced out of the options market by competitive forces, including competition for best execution. Furthermore, options exchanges have trade-through prevention and distributive linkages which virtually guarantee execution at or better than the NBBO. Exception reports widely used by brokers and by some exchanges to determine execution quality identify trades that are executed outside the NBBO at the time an order is received. In light of this, the Committee notes that the NBBO honored when flashed orders miss the NBBO market is based on the NBBO at the time that the order is received at the flashing exchange.

Traditional Exchange Participants, Rather than <u>Maker-Taker Exchange Participants, Set Options Market Prices</u>

In the Release, in question 7, the Commission distinguishes between "aggressive" quotations that are price leaders and narrow the NBBO and "matching" quotations that only follow the NBBO. The Commission asks whether market-makers on traditional exchanges quote aggressively in this sense and whether banning flash orders would increase aggressive quoting on one or both types of exchanges.

In considering the Commission's question, it is important to consider the significant structural differences between equity and options markets. The options market is fundamentally quote driven and the equities market is order driven. Markets at maker-taker exchanges are derived primarily from orders entered based on information gathered from firms that are participants on traditional exchanges and that have invested their capital, both intellectual and monetary, to calculate value and risk associated with pricing options.

Specifically, participants on traditional options exchanges, where the most active participants are professional liquidity providers,[6] set pricing and volatility curves for all options series by virtue of the thousands of quotations they provide. Participants on maker-taker exchanges for the most part are simply reacting to these quotations rather than acting as true price setters. They tend to post quotes that improve prices by a *de minimis* amount that is further reduced or eliminated when an adjustment is made to account for the effect of access fees. A ban on flash orders, regardless of whether the exchange provides "aggressive" or "matching" quotations, would *reduce*, not increase, competition and incentives for aggressive quoting, even if the Commission were to impose a cap on access fees. As previously noted, the Committee believes that a ban on flash orders would push the options markets more toward a maker-taker model, and that this would curtail competition and incentives for aggressive quoting.

The Maker-Taker Exchanges Do Not Foster More Aggressive Quoting

In question 6, the Commission asks whether liquidity rebates are the sole reason that liquidity providers on maker-taker exchanges are willing to quote aggressively. The Committee disagrees with the premise of the question. It is clear to the Committee that maker-taker exchanges do not quote aggressively once quotes are adjusted to account for the access fee paid. Further, the Committee disagrees that liquidity providers at maker-taker exchanges quote more aggressively in the class of options in which they are active even if access fees paid are *not* taken into account. Although they may improve quotes by a *de minimis* amount in a few selected series, they typically provide little or no liquidity in other series. Aggressive quoting and the quality of a market cannot be fairly assessed without taking into consideration size as well as price. As noted above, the method of allocation of executions on traditional options exchanges provides incentives for market-makers to quote in size with the result that the markets on traditional exchanges provide greater depth and price stability. A market structure that moves predominantly or exclusively to a maker-taker model will exacerbate the tendency toward greater market volatility and liquidity vacuums.

Order Execution Quality Statistics Are Publicly Available, and Broker-Dealers Must Ensure Customers' Order Execution Quality Without Regard to Payment for Order Flow

We disagree with the Commission's assumption reflected in questions 3 and 10 of the Release that there is no publicly available order execution quality data. There is a host of order execution quality statistics that are publicly available from various exchanges. Moreover, any lack of data does not eliminate executing agents' responsibility to provide customers with best execution by regularly and rigorously assessing order execution quality. Order execution quality is the responsibility of the broker-dealer handling the order as well as the broker-dealer placing the order.

In response to the Commission's query in question 8 of the Release as to whether flash orders at payment for order flow options exchanges play a significant role in allowing

[6] *See* letter submitted by CBOE in File No. S7-21-09 (November 18, 2009), p. 1.

such exchanges to compete for order flow through broker payments rather than by offering better prices to execute investor orders, it should be noted that all agents for customer orders have best execution obligations and payment for order flow does not prevent these agents from fulfilling this obligation.

Flash Orders Foster Competition without
Suppressing Other Price Improvement Mechanisms

We believe that the competition between the traditional model and the maker-taker model enhances the competitiveness of the options markets. Options markets have the flexibility to adjust their rules to appeal to a particular segment of the market or to reflect reasonable differences of opinion about the balance of costs and benefits of a particular structure. In response to question 9 of the Release, we believe that this flexibility is needed and would be diminished by a flash order ban. The Commission asked, also in question 9, whether the percentage of order flow in listed options that participates in price improvement mechanisms (such as PIP, PIM and AIM) offered by exchanges was less than 1%. Although exchanges can provide more precise data, the Committee believes that the percentage is significantly larger than 1%, and notes that usage of such price improvement mechanisms continues to grow and that such mechanisms are becoming a more important part of the options market structure. This trend has developed concurrently with the use of flash orders, and there is no reason to expect that it will not continue if flash orders continue to be permitted. For these reasons and for the other reasons stated herein, the Committee believes that a flash order ban will reduce rather than increase the competitiveness and efficiency of the options markets and therefore the quality of execution of customer orders.

Cap on Access Fees Would Not Remove Need for Flash Orders

In response to the Commission's first question in the Release, the Committee strongly believes that a cap on access fees would not remove the need for flash orders. Even capped fees would result in aggregate costs to investors, who would no longer have the alternative of obtaining price improvement through flash orders. More importantly, fee caps would do nothing to prevent the loss of market depth in the options market that would likely result from a ban on flash orders. The costs associated with this loss of depth would be far larger than any savings from a cap on access fees.

We believe that the Commission should also take into consideration the routing fees that the Committee anticipates would be imposed even if access fees were capped. The Committee is concerned that a cap on access fees would result in an increase in routing fees, which are not subject to a cap, thus significantly increasing costs and reducing investors' opportunity to receive the price improvement that flash orders currently provide. It seems evident to us that it is the net or "all in" cost of a transaction that is the relevant figure in assessing the quality of an execution. Moreover, because options prices are derived from the prices of underlying assets, increased routing fees would impair the usefulness of pricing formulas used to determine options prices, given that transaction costs and routing fees are not taken into account in such pricing formulas.

Summary and Conclusion

As the Commission has acknowledged, flash orders have clear beneficial effects in the markets.[7] For the reasons discussed above, the Committee believes that flash orders serve a particularly beneficial function in the options markets and are specifically useful in the context of markets following the traditional model rather than the maker-taker model. Flash orders can and often do provide price improvement to the Customers who use them, and rarely result in orders being executed at a price that is inferior to the NBBO at the time the order was received. As the Committee emphasized in December Letter, an investor's use of flash orders is voluntary, and investors are free to determine not to use flash orders if they believe flash orders will harm them. Competition among market models is beneficial to the options market as a whole and provides users of the markets with the opportunity to execute in the market environment that is most suited to their particular needs. The traditional exchanges provide price leadership, liquidity and market depth beyond that offered by the maker-taker exchanges, and these functions would be adversely affected by a flash order ban. An outright ban on flash orders overlooks the significant differences in the market structure of the options and equities markets, and would have the negative effect of encouraging a shift towards a maker-taker model market structure where the rigorous market-making obligations that exist in the traditional options markets are generally not imposed. We believe such a shift toward the maker-taker model would contribute to market volatility and lack of liquidity in adverse market conditions.

The Committee believes that the advantages of flash orders, including increased competition and aggressive quoting, outweigh any of the alleged negative effects of flash orders. The Committee does not believe that the existence of flash orders discourages competitive and aggressive quoting on the traditional options exchange, particularly when quotation size is taken into consideration. To the extent that flash orders might be used as a means of front running or engaging in other manipulative or abusive practices, the Committee supports measures to identify and curtail any such negative effects or abuses that may result from the use of flash orders. Targeted surveillance programs and other regulatory actions are more appropriate means to prevent abusive behavior than imposing an outright ban on flash orders that would not only deprive investors of the many benefits of flash orders, but likely would have unintended adverse consequences on the markets and investors, including an increased risk of significant liquidity gaps and increased price volatility. Indeed, because there is an electronic audit trail of the orders that are flashed and the market participants that are routing orders in the same options at or around the same time, the surveillance process for this type of activity should be very robust.

For the reasons stated above, the Committee respectfully requests that the Commission not eliminate the flash order exception with respect to the options markets. We thank you for the additional opportunity to comment on the Proposal and for your consideration of these views. If you have any questions, please do not hesitate to call me at 212-313-1260.

---

[7] Release No. 34-60684 (September 23, 2009) at 48637.

Sincerely,

Thomas F. Price
Managing Director
SIFMA

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Luis A. Aguilar, Commissioner
The Honorable Kathleen Casey, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Elisse B. Walter, Commissioner
Robert W. Cook, Division of Trading and Markets
James A. Brigagliano, Division of Trading and Markets
Daniel Gallagher, Division of Trading and Markets
Heather Seidel, Division of Trading and Markets
David Shillman, Division of Trading and Markets
Daniel Gray, Division of Trading and Markets
Steve Williams, Division of Trading and Markets
Theodore S. Venuti, Division of Trading and Markets