

Aug 23, 2010

*Via Electronic Submission and Mail*

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-0609

Re: Release No. 34-62445; File No. S7-21-09 (Flash Orders - Options)

Dear Ms. Murphy:

Susquehanna International Group, LLP<sup>1</sup> (SIG) appreciates the opportunity to comment on the above-captioned Release. We were pleased to see the Securities and Exchange Commission (“the SEC” or “the Commission”) seek additional comments for options flashing. We agree with those who see a difference between equities and options in this regard and we likewise agree that they should be looked at separately<sup>2</sup>. Although flashed volume may only constitute about 1% of overall order volume on traditional option exchanges, the ability to flash and step-up nonetheless remains an important component to the market structure for options. We believe public customers benefit in a number of ways from the step-up feature to flashing and we recommend that the SEC continue to allow flashing in options.

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<sup>1</sup>SIG is comprised of multiple trading and investment affiliated entities. Some SIG affiliates operate as options market makers and others operate as agency brokers in listed options.

<sup>2</sup> While the roles they play in the two marketplaces differ considerably, the flash mechanisms themselves operate in much the same manner for options as they do for stocks. That is, a flash-able order is one whose price is marketable on an NBBO basis but is received at an exchange that is showing a price inferior to the NBBO. The flash occurs when the order is shown exclusively to eligible participants in the receiving home exchange for a short flash-period. The hope of the home market is that one of the eligible participants will provide a flash-fill by matching or improving the flash price of the away market (i.e., “the step-up”). If the order does not receive a step-up, it is then re-routed away to trade at the away market.

Flashing is a win-win situation for public customers in options. We conservatively estimate that over 70% of flashed retail-type option orders<sup>3</sup> receive a step-up execution from option market makers (MMs). Many of these executions also benefit significantly from liquidity enhancements<sup>4</sup>. Additionally, the cost savings to traditional exchanges (and ultimately to customers) from avoiding high taker fees through a step-up rather than a reroute is also significant. As to missing away markets during a flash period, this happens in a very small percentage of instances, and firms have post-trade review procedures in place to help ensure that their public customer orders receive the best price available at original receipt time. Of course, in this connection, exchanges should nonetheless be encouraged to continue in their efforts to reduce flash-periods and further ensure that customers always benefit appropriately on rerouted orders.

In order to fully understand how flashing helps options customers, it is first necessary to understand the different ways options market-makers (MMs) compete with quotes. Having this understanding is especially important in the options market because it is primarily a quote-driven market (rather than order-driven) with over 90% of the liquidity provided by registered options MMs.

Options MMs operate under two basic MM models: the *price-time maker-taker* model (“price-time”) and the *pro-rata traditional* option model (“pro-rata”)<sup>5</sup>. Although the vast majority of option liquidity is provided through the pro-rata model, and although the two models contrast in most other respects as well, there is nonetheless some valuable offsetting interplay between them that provides a competitive balance that has shown to be beneficial to customers. It is important to consider the benefits of this interplay because a ban on flashing could ultimately result in some or all of its loss.

In addition to the two basic models, a third hybrid model also needs to be mentioned. This third model is the *pro-rata maker-taker* model that one exchange has adopted for some of its options, and others may also be considering. For the purpose of assessing the value of flash functions in the context of the liquidity step-up MMs provide, however, this model is functionally viewed as a pro-rata model given the type of quotes it generates. This is also the case with respect to any pro rata market that offers rebates for stepping up. All in all, the various models combine to give the options market a very diverse mixed-market structure.

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<sup>3</sup> We use customer orders of 20 contracts or less received electronically through a router at a traditional exchange as a general gauge to define retail-type orders.

<sup>4</sup> Though retail-type orders are generally smaller-sized orders, they are nonetheless often larger than the quotes displayed at the away maker-taker markets. Liquidity enhancements refer to when a step-up provides more contracts to the customer than are disseminated at the NBBO on away markets.

<sup>5</sup> The “price-time maker-taker” market in this instance assumes a price-time priority among orders and an access fee to take liquidity (notwithstanding special split rules may apply in limited circumstances). The “traditional” or “pro rata” market refers to markets with pro rata distribution on price parity executions, which awards a greater participation rate (in a parity situation) to those quoting in larger sizes.

As to the differences in the two basic models, generally speaking, price-time MMs quote in smaller sizes. Moreover, many of them follow a selective low-risk strategy of quoting with small-lots to improve the NBBO by a minimum differential in an effort to capitalize on the quote-maker rebates. The pro-rata MMs, on the other hand, quote aggressively in much larger bid/offer sizes and in a much broader range of option series. They focus more on setting prices and providing liquidity for the full range of option customers.

While some price-time MMs often compete aggressively with substantive quotes, those that rely primarily on the very selective, penny-better/smaller-sized “gaming” strategies create a great many of the flash instances that result in step-up executions. In consideration of the debate surrounding the extent to which these price-time gaming MMs may or may not produce a net favorable effect for customers, it naturally comes down to one’s point of view. For instance, in one way of thinking, rebating a MM to quote and trade in small amounts at a small price differential, and paying the MM a significant portion of the difference with money obtained by charging the incoming order a higher than normal transaction charge, is partially bona fide market making and partially a shell game designed to use rebate fees to exploit the larger-sized commitments of MMs at the pro-rata exchanges. In another way of thinking, the price-time MM strategies sometimes contribute to better execution prices for customers – whether by way of a direct route, step-up or reroute. Consequently, regardless of the issues that arise from the gaming aspect of the price-time MMs, it appears that for now there is a reasonably healthy balance of competition between the two MM models. It also appears that flashing helps maintain that balance at a level beneficial to public customers.

Even though pro-rata MMs may view the gaming aspect of certain price-time quotes as a liability to their own efforts to show larger sizes, the activity does not appear to create a liability to the investing public. To wit, pro-rata MMs continue to show aggressive quotes in large sizes in hundreds of thousands of option series throughout each day even while price-time MMs lean on a portion of those quotes with smaller-lot quotes at penny-better prices. Meanwhile, the high taker fees on reroutes are currently absorbed by the traditional exchanges. In sum, the net affect appears to be that public customers are enjoying the best of all worlds from the current blend of quotes from the mixed market structure.

The notion that price-time MMs “lean on” the pro-rata quotes refers to the scenario where the price-time MMs use the larger quotes of the pro rata MMs as a backstop and volatility-checking monitor, which ensures that the risk of their own penny-better/smaller-lot strategies is minimized. With less market risk to worry about, the price-time MM can better focus on capturing the maker-rebates.

The overlying concern with this activity, however, is that selective rebate-driven quotes for 10-lots at a price one-penny better than away quotes for 100 contracts are generally only good for customers if it does not lead to a restructuring in the options market whereby the larger-sized MMs migrate into becoming 10-lot quote makers themselves. Indeed, the overall question with respect to flashing is whether a ban will create a chain of events that lead to pro-rata MMs becoming price-time MMs. In this connection, the ultimate question underpinning the flashing matter for options is (a) whether the two approaches work better together or (b) whether it is best to have one model dominate.

We believe that any significant migration by options MMs toward the price-time model would be a change for the worse in the way options are quoted and traded. In a price-time dominated environment, being first with the quote would be rewarded and providing depth with the quote would be discouraged. Liquidity levels would suffer dramatically not only at the NBBO displayed prices but also at the next price levels where added depth currently serves to bolster the market and protect against liquidity gaps. One need only look at the equity market to see what sorts of troubling effects a dominant price-time model can have during volatile periods. We know, for example, from the flash-crash of May 6<sup>th</sup> that a lack of depth liquidity can translate into large liquidity gaps between price levels. Perhaps this is the time to step back and appreciate that the options market of today is not yet dominated by high-frequency, smaller-sized, rebate-driven, risk-averse, penny-gaming strategies that lean-on the larger quotes of competitors. Indeed, this is not the direction that should be sought for the options market.

Although the market-efficiency benefits of flashing are in ample evidence, some people naturally speculate that if the same pro-rata MMs that step-up would instead simply reflect the tighter markets to begin with, there would be no need to flash in the first place. This question belongs in the category of ‘be careful what you wish for’ because, as indicated above, changing quoting behavior by sacrificing large amounts of displayed liquidity in a broad range of option issues to instead be a penny tighter in a relatively few number of option series would not be the best thing for the options market. Also, as it stands now, the pro-rata MM that elects to step-up is already showing its best price prior to the flash. The step-up is a response to the information about the order (e.g., size and nature of the order) obtained during the flash.

Fortunately, pro-rata MMs would not be inclined to change their larger-sized quoting practices in any material way if flashing is banned, given that flashing constitutes such a small part of overall option activity. A ban would, however, pose the risk that pro-rata *exchanges* would migrate to the price-time maker taker model. Simply put, the reroute fees could grow to a level where the traditional exchanges would no longer be

able to justify absorbing them<sup>6</sup>. If such a migration to the price-time model happens, the pro-rata MMs would adjust accordingly to the new model and the result would be a market structure similar to the one we have in equities. This would result in a tremendous overall loss of liquidity to public customers as pro-rata MMs would lose their incentive to quote in larger sizes.

The manner and degree by which the pro-rata model provides relatively high levels of liquidity in options is best understood through a basic risk-reward analysis. Pro-rata MMs disseminate larger sized quotes on traditional exchanges to secure higher pro-rata parity allocations on incoming customer orders. In fact, they often disseminate quotes in sizes greater than what they would optimally like to trade. This being the case, the pro-rata MMs must be concerned about aggressive, and well informed, orders that take out their complete sizes ahead of unfolding (or non-public) market developments. The risk of the unknown nature and full interest of large incoming orders is weighed against the greater pro-rata participation. Consequently, given this fear of the unknown, while the pro-rata MMs routinely quote in large sizes they are often apt to step-up for smaller orders when they become aware of the order size during the flash period. That is, knowing that the order is smaller in size reduces risk and that prompts the pro-rata MM to step-up.

With knowledge as to the size of the order, the risk-factors surrounding the unknown are reduced and liquidity is increased through the step-up. This explains the high rate of step-ups for retail-type orders, but it does not explain why there are so few eligible flash orders in options to begin with. The answer to that question rests within the fact that pro-rata MMs already quote aggressively on price as well as size. Indeed, the options market is already a highly competitive and efficient marketplace that benefits tremendously from the pro-rata MMs' ability to keep quotes tight throughout the day. While it is doubtful that pro-rata MMs would change their quoting behavior at all because of a ban on flashing, any change by them that results in a reduction of quote sizes could conceivably damage the balance within the current market structure – even if it did not lead to a complete migration to the price-time model.

In deciding the fate of flashed orders, it is important to understand the limited degree to which the gaming price-time MMs improve the NBBO and the significant degree to which public customers rely on the liquidity offered by pro-rata MMs. In this regard, SIG conducted a review of trading in the “penny” eligible equity options for a recent month. From that review, it was evidenced that over 90% of the time when a single option execution occurred while a price-time quote established the best bid or offer, the price improvement was for the minimum differential (i.e., one penny). Also, it was found that most of those times the aggregate size of the quotes at the penny-better

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<sup>6</sup> The fact is that this concern is already growing given the emergence of the “pro-rata maker taker” model and the increasing reroute costs it is creating for the traditional exchanges.

price from the price-time markets was for less than 20 contracts while the aggregate size of the penny-worse quotes from the pro-rata markets averaged twenty times larger<sup>7</sup>. In other words, while the price difference is almost always minimal, the difference in quote size is usually staggering.

Remembering that these gaming strategies are currently only deployed in select series at select times, the related question is how well option exchanges would service the needs of the investing public in general if all that is offered to the public is price-time maker-taker markets. The Commission should look further into these factors to gain a full appreciation for the impact of what could happen to quote liquidity in general before imposing any ban on option flashing.

With respect to the matter of access fees, although taker fees on maker-taker markets are in most cases exorbitantly high, such that extensive re-routing of small lot orders causes significant costs, the commitments by the traditional markets to absorb these costs serves the critical role of maintaining the current structure in a cost effective manner for customer houses. The lynchpin to keeping these counter-balancing forces in sync, of course, is the ability for MMs to step-up on flashed orders. If, in the alternative, the flash is banned and taker-fee absorption costs skyrocket, this is where the danger most arises that the markets will migrate to that price-time model. As previously mentioned, at some point it will not be worth it for the exchanges to absorb the costs. The recent proposal to cap the access fee is certainly a meaningful step in the right direction, but if flashing is banned, the overall cost to the traditional exchanges would be much higher than it is today because more orders would be routed. Again, the emergence of the pro-rata maker-taker model is also adding significantly to that cost.

As to the concern raised in regards to frontrunning and flashing, frontrunning in any form is a concern that must always be taken seriously by market participants. In the case of flashed option orders, the concern is ameliorated to some degree because the routes are generally for small lots and the liquidity providers at both ends are predominantly registered MMs. This being the case, the option exchanges retain the necessary jurisdictions and the related activities can be closely monitored. It should also be remembered that, in accordance with rules governing the activities of MMs, trades by MMs must, in one way or another, be in furtherance of their MM obligations. Thus, any attempt by a MM to capitalize on information about an unexecuted flashed order would be in apparent violation of the rules. In addition, any effort by an eligible participant to frontrun a flashed order will leave an indelible

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<sup>7</sup> SIG reviewed the month of June 2010. That month, we found that there were 263 “penny” equity option classes that had single executions at the NBBO price while either or both major price-time markets were showing that best displayed price. The single-trade isolating qualifier was to filter out “blast orders” and large working orders and thereby better assess the value of the quotes between the two models for customers under flash related conditions.

electronic footprint so that exchanges are able to conduct robust surveillance reviews. While frontrunning concerns in options should never be underestimated, an audit trail of flashed orders and related activities will provide an excellent deterrent.

While we have attempted above to respond to the questions surrounding flashing as they relate to liquidity and fairness, the Commission also raised in the Release a concern about two-tiered markets. On this point, as discussed above, the pro-rata MMs provide deep liquidity at fair market values while price-time MMs sometimes use those quotes in their rebate driven strategies. Although this may not be a perfect case of symbiosis between the two MM types, the dynamic nonetheless appears to serve a purpose in setting fair prices with deep liquidity while also creating price improvement for public customer orders. Given the relatively favorable status quo, the more salient point in regards to the two-tier market concern is that although these two models are very different they nonetheless combine to improve upon best execution for customer orders.

Finally, with respect to the concern about transparency and flashing, we note that step-ups come not from any attempt to avoid transparency, but rather, in response mostly to factors that arise during the flash (e.g., learning the size of the order). Moreover, flashing promotes transparency because it helps maintain the ability of pro-rata MMs to display large sized quotes in the vast majority of series.

We do, however, believe the issue of transparency is a growing concern in the options market given the many recent initiatives by certain exchanges to adopt internalizing rules that are designed to side-step transparency. For this reason, we are encouraged to see the SEC focused on the issue.

More specifically, we hope that while on the subject of transparency the Commission will address the obvious transparency issues raised by exchanges through recent rule filings seeking or gaining the ability to internalize facilitation trades without competitive auctioning even within their own marketplaces. The ISE's Qualified Contingent Cross proposal (QCC) is a good example of a proposal that does indeed deprive customers of transparency and competition in options<sup>8</sup>. When a facilitator is given full priority on options blocks over competitors in the same market place at the same price, and is not required to auction or display the block interest before facilitating it, the result is that customers may suffer both from the immediate absence of competition and, in the long-term, from withdrawal of competitive quote making by MMs. If transparency is a concern in the options market, then the QCC proposal should be denied because it is the quintessential example of non-displayed trading interest by a facilitator being matched with unannounced trading interest of a customer. This is very different than flashing, which auctions orders among multiple

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<sup>8</sup> SR ISE 2010-73 SR ISE 2009-35

MMs for a better and cheaper execution before a reroute. While recent statistics indicate that over one-third of option volume is constituted by blocks of 1,000 contracts or more, we estimate that most of those blocks involving customers also involve near concurrent stock hedging. This means that the QCC proposal, if approved, would have a significant effect on the way competitors (particularly pro-rata option MMs) quote and interact in the market.

In regards to transparency issues with options in general as of late, it seems that when it rains it pours. Similar in most respects to the QCC issue, the ISE and NASDAQ-OMX now have a rule that allows brokers to display one contract from a block order and after one second facilitate the balance of the order without any public display. This is another example of rule making that by its very design serves to stymie competition in the options market<sup>9</sup>. Also, in a similar vein, the NYSE-ARCA has recently proposed a rule change that seeks to require floor based market makers to disclose their final markets in a series when a floor broker queries the trading crowd prior to the disclosure of an intention to effect a block cross transaction. This practice may deprive customers of better executions and allow brokers an opportunity to engage in the practice of “venue shopping.” That is, without fully working the order for best execution and attempting to elicit superior trading interest from the local trading community, the broker is now more able to effect a trade without due diligence or may retreat and take the order to another trading venue to effect the cross transaction at a desired price, which may not be the best available price.<sup>10</sup>

While we understand the premise that electronic markets are at a disadvantage to floor markets that presumably (but not necessarily) can offer cross blocks with less risk of being broken up, awarding non-competitive rules as consolation is a case of two-wrongs not making a right. The much better solution is to require floor crosses to be entered into an electronic crossing mechanism where MMs in that series on that marketplace can compete to ensure best execution. This would be an excellent area to target for rule changes that truly would result in more transparency and fairness for investors.

In addition to the concern that the Commission is being asked by certain exchanges to allow block crosses to occur without reasonable levels of competitive scrutiny, the notion about diminished transparency also arises in the context of smaller-lot orders. Indeed, we are concerned with the growing instances of exchanges establishing barriers in the form of discriminatory fees that restrict access to markets that, in turn, further denies customers the most competitive prices for their orders. We note, for example, recent fee schedule changes by the BOX that now add additional charges that nearly double the cost of access to those market participants that wish to improve

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<sup>9</sup> NASDAQ OMX Chapter VI Rule Section 1(e)(4), ISE Rule 715

<sup>10</sup> SR NYSE ARCA 2009-69

the prices being offered to customers during a Price Improvement Process (PIP) auction.<sup>11</sup> We wonder about the transparency value that goes unrealized when exchanges are allowed to penalize competing MMs with astronomical fees when they attempt to participate with or improve the customer side to a pre-set matched order.

Similarly, the NYSE-Amex recently raised Trading Permit fees for MMs by a factor of five while leaving the permit fee for brokers unchanged.<sup>12</sup> The Market Maker Trading Permit fee now stands at ten times that of a Floor Broker. Although such fee increases when considered outside of this environment might be considered mostly benign, this action could reasonably be viewed as an attempt to drive away floor based MMs who are the parties most likely to intervene in an attempted cross by providing better prices for customers.

In light of the fact that the Commission is being asked to consider a host of rule changes designed to diminish transparency in the options market, we believe that the transparency concern is timely. In this connection, flashing promotes transparency by helping to safeguard the dissemination of larger-sized liquidity interests while ensuring that customers receive the benefits of better-priced liquidity at away markets in those select instances.

In conclusion, flashing is a benefit to public customers and promotes competition among option MMs. So long as pro-rata MMs can continue to step-up for small-lot customer orders, we can expect that they will continue making greater sized markets for all sized orders and thereby balance the needs of the marketplace. In this way, larger sized customers can also continue to receive liquidity in the sizes and at the prices they need. If pro-rata MMs are not allowed step-up capabilities, it will result in more costly executions for customers large and small and, perhaps, lead to a migration to the price-time maker-taker model. An options market dominated by price-time maker-taker exchanges would not be beneficial to public customers who have historically benefited by low transaction charges and MM driven quote competition. For the most part, again, the current structure provides the best of both worlds for customers.

Should you have any questions with respect to this letter, please feel free to contact me. Again, thank you for this opportunity to respond.

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<sup>11</sup> SR BX 2010-049

<sup>12</sup> SR NYSE Amex 2010-10

Sincerely,

A handwritten signature in black ink, appearing to read "Gerald D. O'Connell". The signature is fluid and cursive, with a large initial "G" and "O".

Gerald D. O'Connell  
SIG – Chief Compliance Officer

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  
James A. Brigagliano, Division of Trading and Markets  
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Henry Hu – Risk, Strategy and Financial Innovation