MEMORANDUM

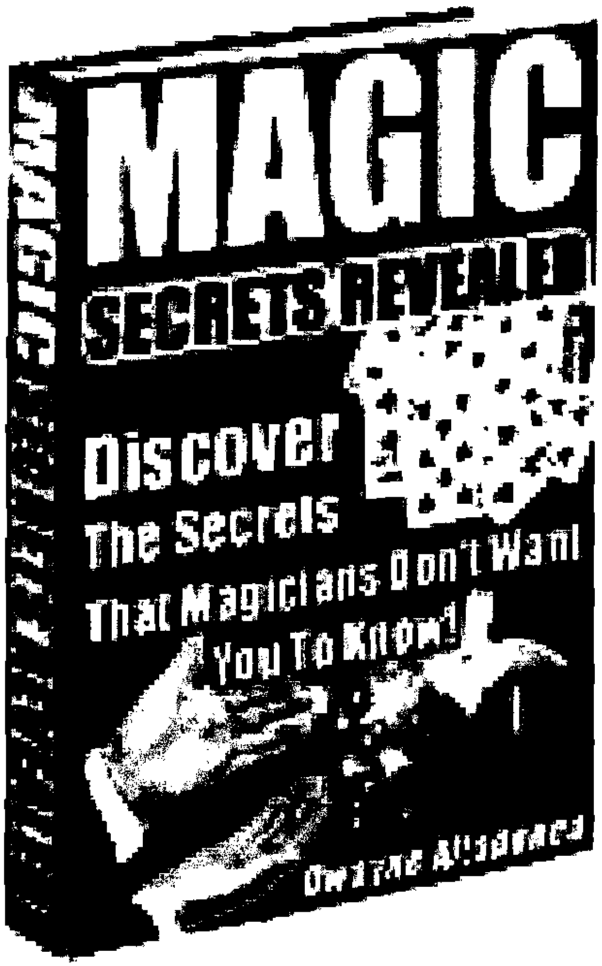
TO: File No. S7-21-09

FROM: The Division of Trading and Markets

DATE: October 16, 2009

RE: Proposed Elimination of Flash Order Exception from Rule 602 of Regulation NMS

On October 16, 2009, Staff in the Division of Trading and Markets met with Gary Katz, Chairman and Chief Executive Officer of International Securities Exchange, LLC ("ISE") and Katherine Simmons, Deputy General Counsel, ISE regarding the above-referenced proposal. Representatives of ISE also provided a presentation titled "The Illusion of Maker Taker Markets."



The illusion of maker taker markets

Equities

[redacted]

[redacted] 12% sent to TRFs

[redacted] 8-9% sent to TRFs

[redacted]

- Funneling process removes "good" order flow
- Exchanges are left with "exhaust"
- Market makers don't like "exhaust"
- As a result, maker taker fee structure develops in order to incent market making , i.e. two-sided markets

This works well for equities

Options

[redacted]

[redacted] 5% Crossed on Exchanges

[redacted] 0%

[redacted]

- Funneling process limited to only large orders
- Exchanges have "good" order flow
- Market makers make money trading good flow
- As a result, "classic fee" structure where market makers are still willing to pay to trade with incoming order flow remains strong

This works well for options

[redacted]

[redacted]

Number of securities and daily transactions are rounded

Fact:

Because options are derivative instruments, providing a market maker a rebate of $0.30 allows a “maker” to improve the quoted market.

This is based on fair value mathematics and has been empirically proven in the market place.

Today, we see that maker taker markets are better than “classic fee” markets between 15% and 25% of the time.

Myth:

If you allow “Flash,” maker taker market makers will not improve their quoted market. That is, “Flash” discourages competitive quoting.

Fact:

Options are a derivative instrument – mathematically, with a rebate, a market maker’s model improves the quote a certain percentage of the time dependent on the size of the rebate.

Where does everyone sit on the see-saw?

In a maker taker market, larger maker rebates produce better quotes but require higher taker fees….. as they increase, the SEC will hear calls for a "cap" from "Classic" market makers and retail brokers

If the "cap" is made too high, it is harder for "classic" market makers to match the improved quotes and retail brokers do not want to pay high taker fees. Also, too high a "cap" distorts price transparency.

options now:
30¢ maker
45¢ taker

If the "cap" is made too low, maker taker market makers can't improve the quality of the quote often enough.

A balance with both structures is good for the industry

[redacted] **75%** [redacted]

of the time the quotes are the same

Who receives fee for a trade:

Market Maker	$0.30
Exchange	$0.15
	$0.45

Who pays fee for a trade:

Broker	-$0.45
Customer	-$0.00
	-$0.45

Who profits from the trade/spread:

Market Maker	$0.60

(MM makes total of $0.90)

Who receives fee for a trade:

Broker (PFOF)	$0.25
Exchange	$0.08
	$0.33

Who pays fee for a trade:

Market Maker (Fee + PFOF)	-$0.33
Customer	-$0.00
	-$0.33

Who profits from the trade/spread:

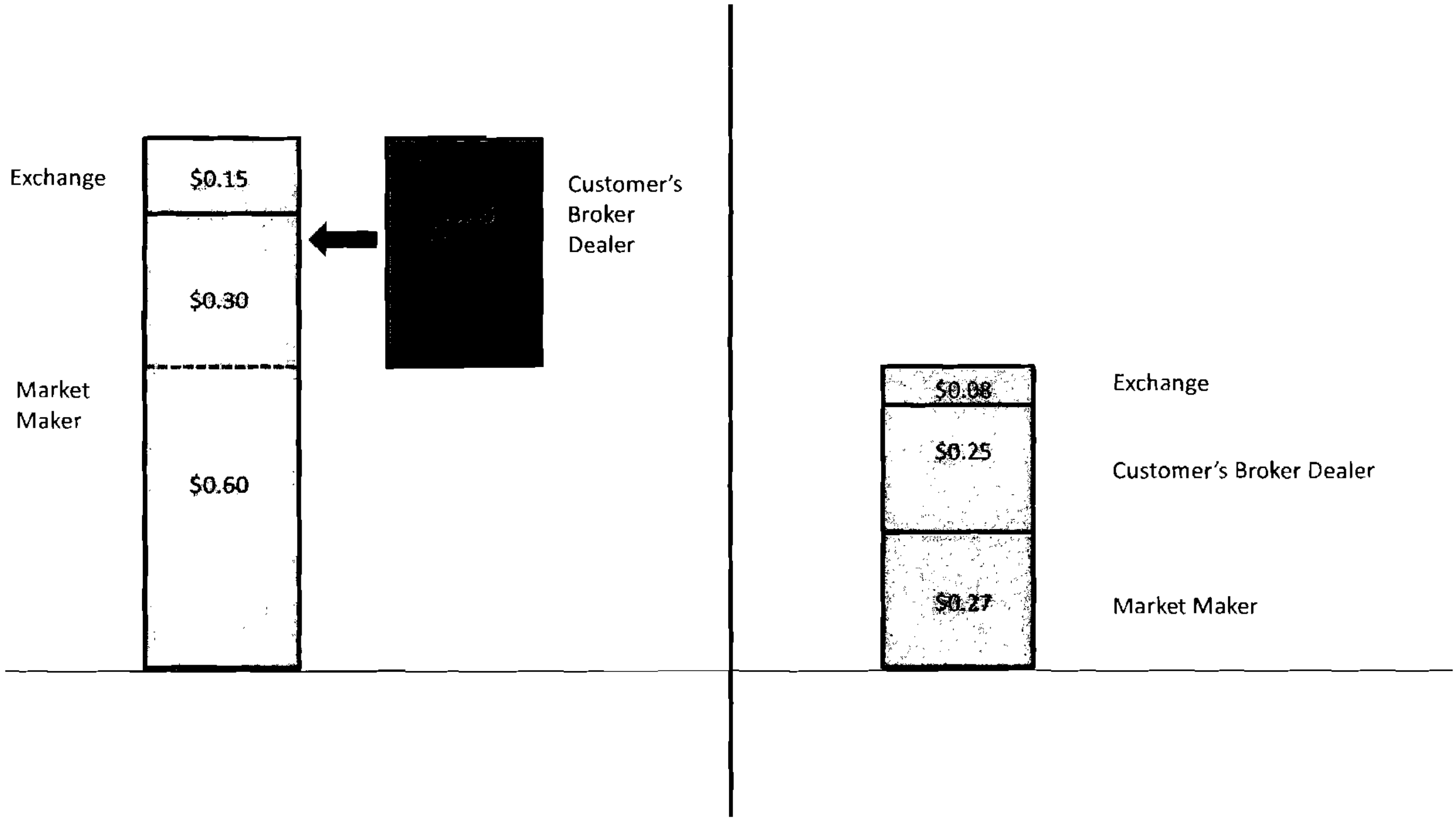
Market Maker	$0.60

(MM makes total of $0.27)

Prices vary based on the exchange, market maker expertise, transaction volume and PFOF arrangements

[redacted] 75% [redacted]

of the time the quotes are the same



Prices vary based on the exchange, market maker expertise, transaction volume and PFOF arrangements

So, if a market maker in a "classic fee" structure only makes $0.27 vs. $0.90, why do they stay there?

Why don't they go to a maker taker market where the yield is higher?

In a "classic fee" model, pro-rata combined with preferencing allows the market maker to trade more often in greater size allowing them to make the $0.27 more often with better control of risk.

[redacted] **25%** [redacted]

of the time the quotes are different

When [redacted]

Who receives fee for a trade:

Market Maker	$0.30
Exchange	$0.15
	$0.45

Who pays fee for a trade:

Broker	-$0.45
Customer	-$0.00
	-$0.45

Who profits from the trade/spread:

Market Maker	$0.10*

(MM makes total of $0.40)

Who receives fee for a trade:

Broker (PFOF)	$0.00
Exchange	$0.00
	$0.00

Who pays fee for a trade:

Market Maker (Fee + PFOF)	-$0.00
Customer	-$0.00
	-$0.00

Who profits from the trade/spread:

Market Maker	$0.10*

(MM makes total of $0.10)

* In both cases, assumes some edge is lost when the quote is improved by a penny

Prices vary based on the exchange, market maker expertise, transaction volume and PFOF arrangements

[redacted]

[redacted] **25%** [redacted]

of the time the quotes are different

When [redacted]

Exchange $0.15

Market Maker $0.30

$0.10

[redacted] Customer's Broker Dealer

$0 Exchange

$0 Customer's Broker Dealer

$0.10 Market Maker

Prices vary based on the exchange, market maker expertise, transaction volume and PFOF arrangements

[redacted] **25%** [redacted]

of the time the quotes are different

NO FLASH

Who receives fee for a trade:

Market Maker	$0.30
Exchange	$0.15
	$0.45

Who pays fee for a trade:

Broker	-$0.45
Customer	-$0.00
	-$0.45

Who profits from the trade/spread:

Market Maker	$0.10*

(MM makes total of $0.40)

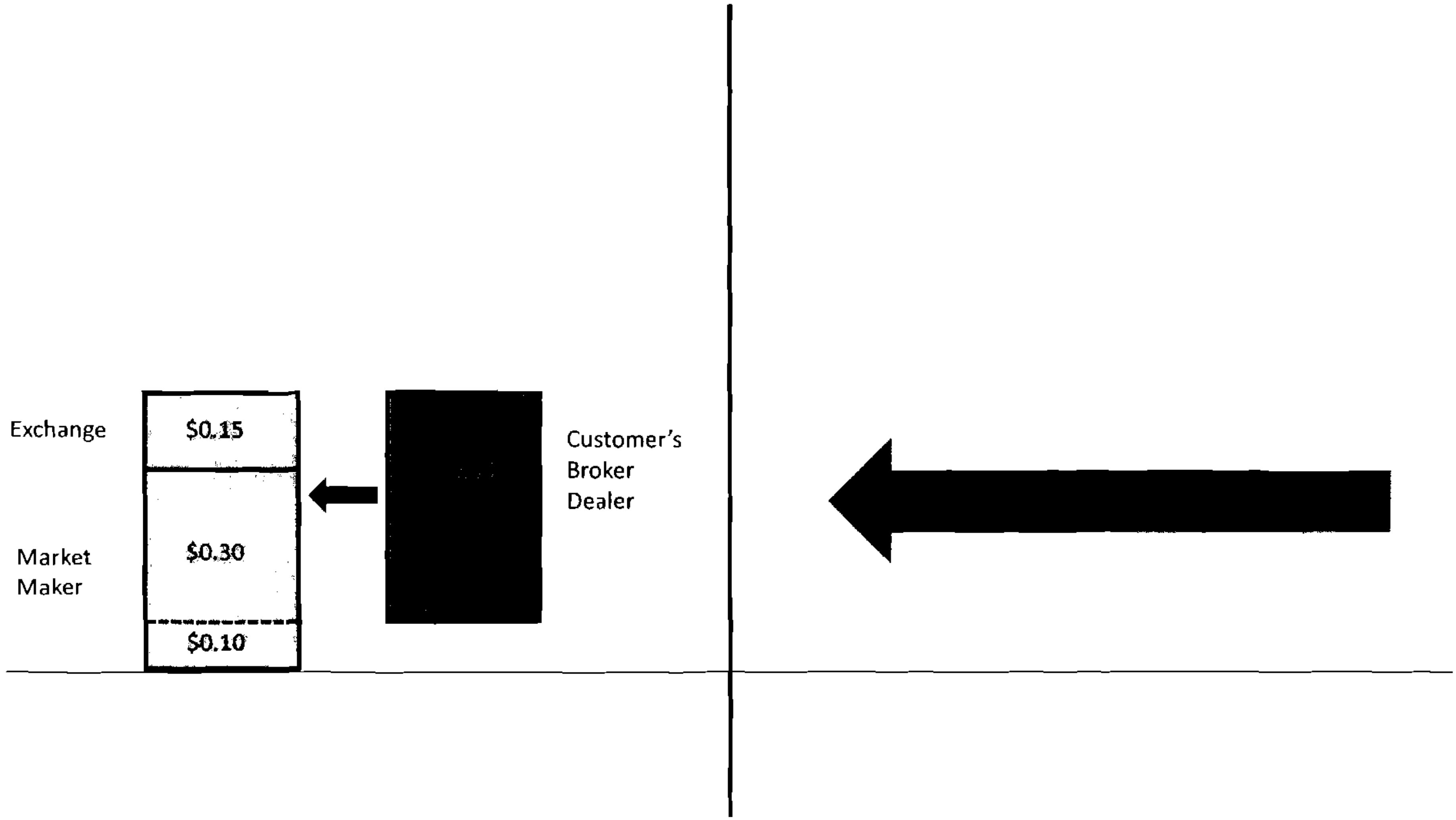
* Assumes some edge is lost when the quote is improved by a penny

Prices vary based on the exchange, market maker expertise, transaction volume and PFOF arrangements

[redacted] **25%** [redacted]

of the time the quotes are different

NO FLASH



Prices vary based on the exchange, market maker expertise, transaction volume and PFOF arrangements

Banning Flash in Options:

- Rewards maker taker exchanges
- Rewards maker taker market makers
- Penalizes "classic fee" exchanges
- Penalizes retail brokerage firms

[redacted]