MEMORANDUM

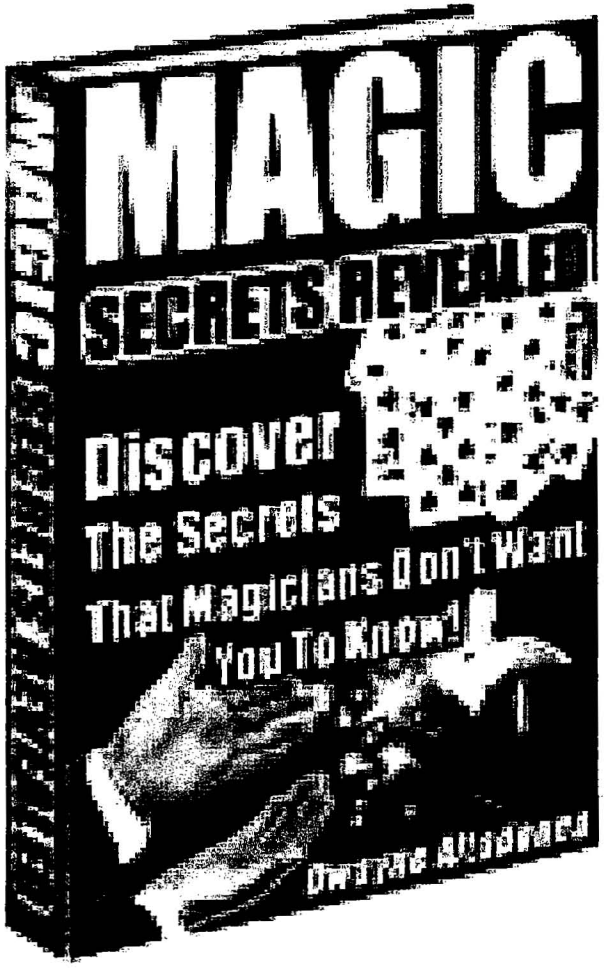
TO: File Nos. S7-21-09, SR-ISE-2009-35

FROM: Michael E. Coe
Office of Commissioner Luis A. Aguilar

DATE: November 2, 2009

SUBJECT: Meeting with Representatives of International Securities Exchange

On October 16, 2009, Commissioner Aguilar and Michael E. Coe, Counsel to the Commissioner, met with International Securities Exchange representatives Gary Katz, President and CEO, and Katherine Simmons, Deputy General Counsel. The discussion included, among other things, the Commission's proposed rules regarding flash orders and the views expressed in ISE's Motion to Lift Automatic Stay dated September 11, 2009. Mr. Katz provided the attached presentation, entitled, "The Illusion of Maker Taker Markets" and the attached chart entitled "Equity Market Share."



The illusion of maker taker markets

In equities, payment for order flow and preferencing takes place before the order gets to the exchange. A large amount of "good" flow is internalized.

This "works" because there is still enough flow coming to the exchanges.

(7000 securities, 40 million transactions daily)

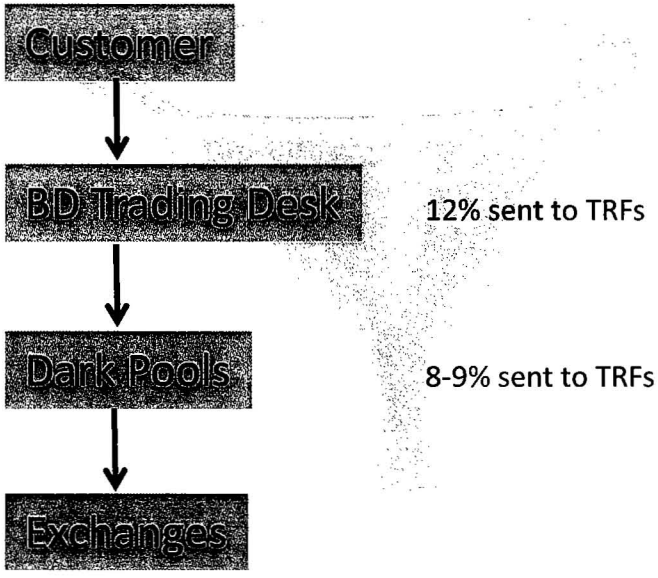
In options, payment for order flow and preferencing takes place after the order gets to the exchange. The SEC's sanctioned balance allows for some on-exchange internalization while keeping the flow in the market for price discovery and competition.

This works because there is not enough flow in options for the equity market model to work.

(275,000 securities, 750k transactions daily)

Number of securities and daily transactions are rounded

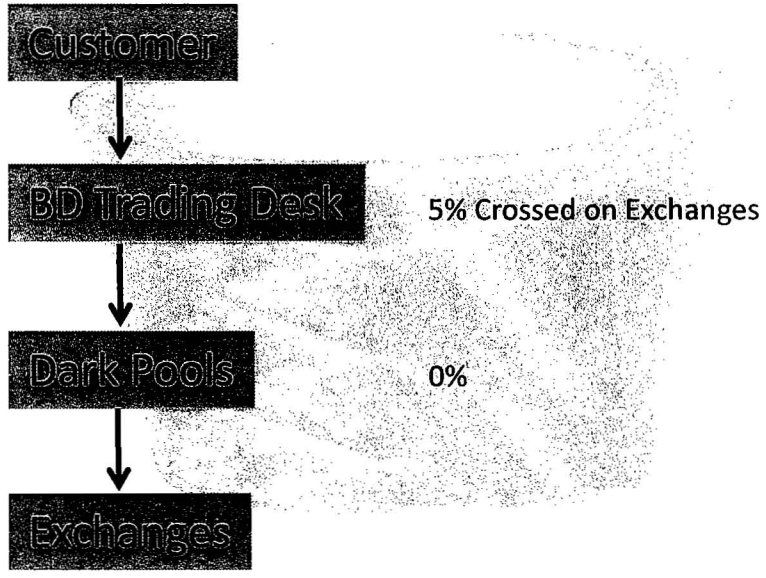
Equities



- 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



- 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

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.

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

Maker – Taker Pricing

75%

"Classic" Pricing

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

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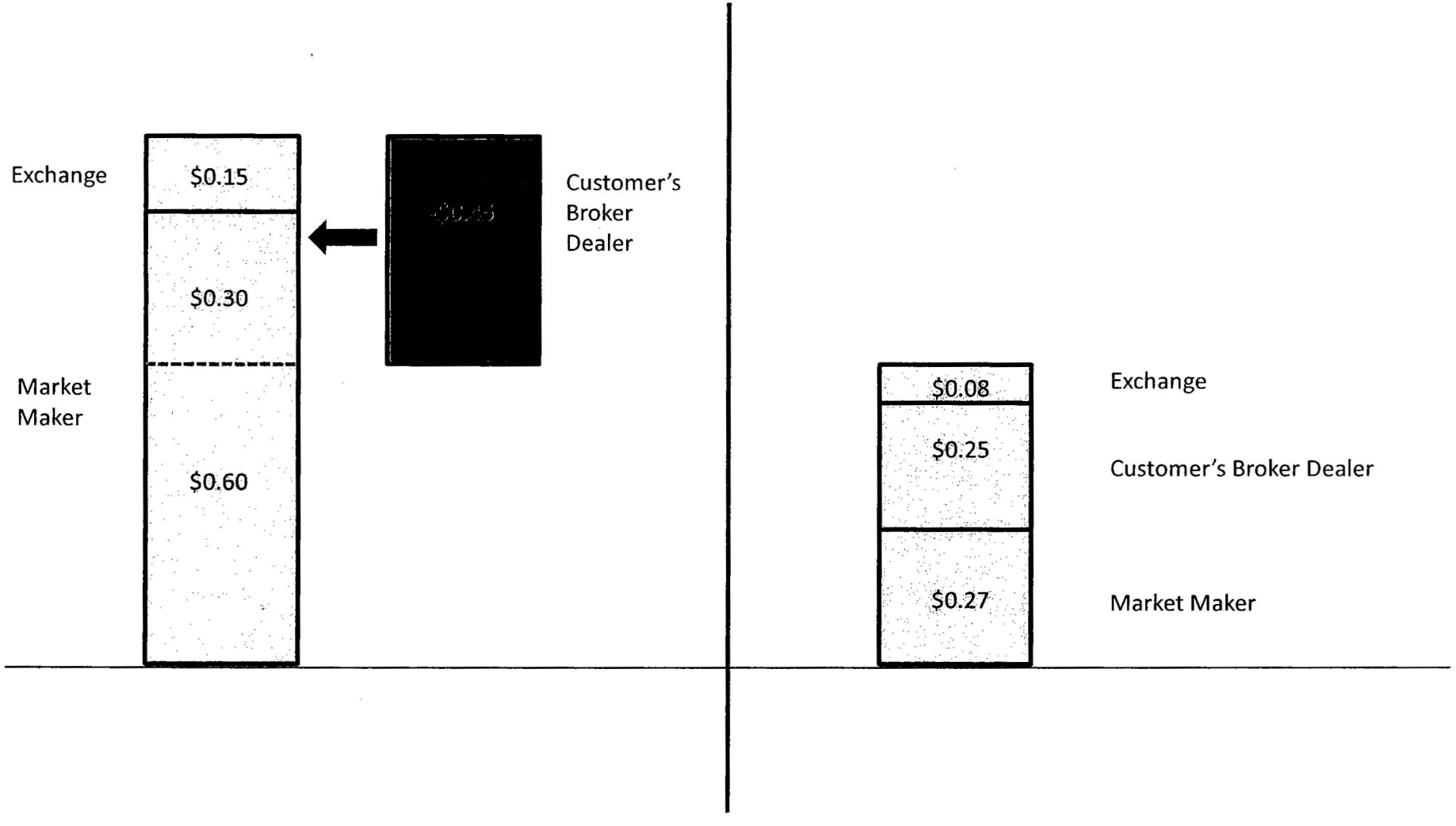
75%

"Classic" Pricing

of the time the quotes are the same



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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.

Maker – Taker Pricing	25%	"Classic" Pricing When Flashed

of the time the quotes are different

Who receives fee for a trade:	
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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)	

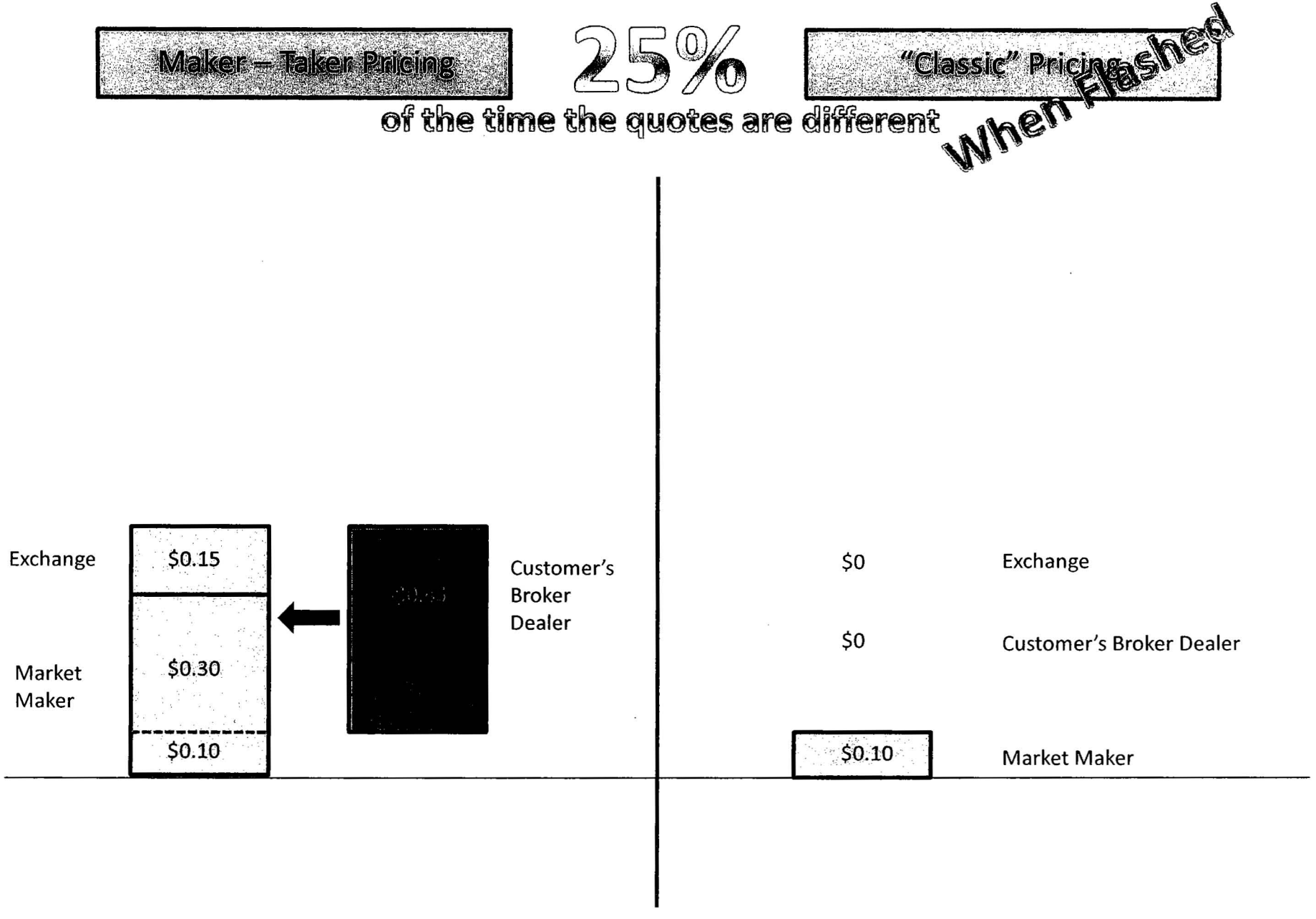
Who receives fee for a trade:	
Broker (PFOF)	$0.00
Exchange	$0.00
	$0.00

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



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

Maker – Taker Pricing

25%

"Classic" Pricing

NO FLASH

of the time the quotes are different

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Market Maker	$0.30
Exchange	$0.15
	$0.45

Who pays fee for a trade:	
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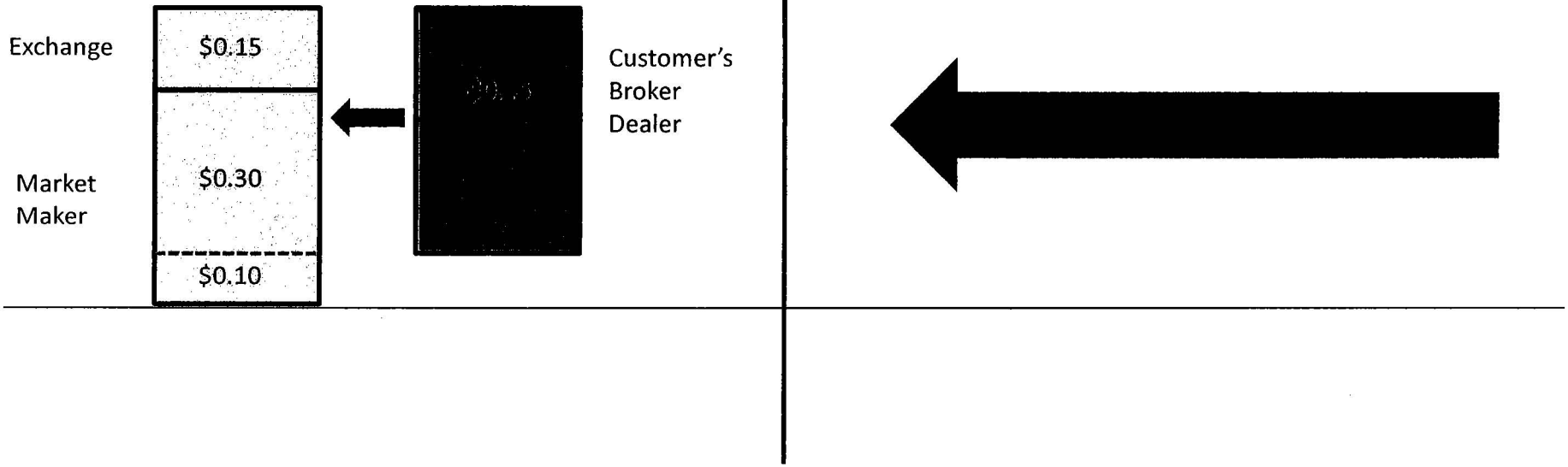
Maker – Taker Pricing

25%

of the time the quotes are different

"Classic" Pricing

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

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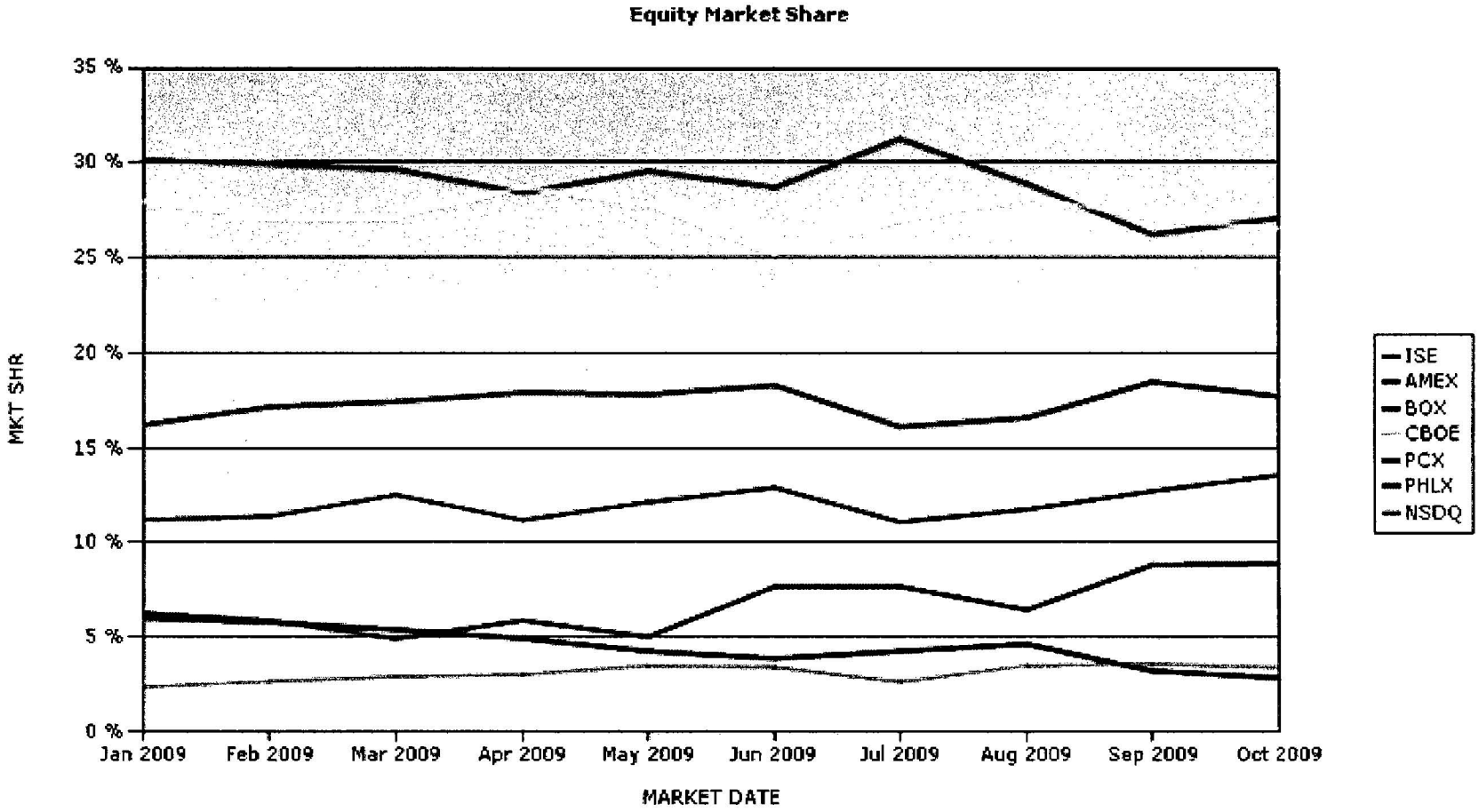
Equity Market Share
35 %
30 %
25 %
20 %
15 %
10 %
5 %
0 %
MKT SHR
Jan 2009
Feb 2009
Mar 2009
Apr 2009
May 2009
Jun 2009
Jul 2009
Aug 2009
Sep 2009
Oct 2009
MARKET DATE
ISE
AMEX
BOX
CBOE
PCX
PHLX
NSDQ