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November 23, 2009

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

Re: Elimination of Flash Order Exception from Rule 602 of Regulation NMS; Release No. 34-60684; File No. S7-21-09

Dear Ms. Murphy:

I. Introduction

Global Electronic Trading Company ("GETCO")[1] appreciates the opportunity to comment on the above referenced proposal ("Proposal") to amend Rule 602 of Regulation NMS to eliminate an exception for the use of flash or step-up orders by equity and options exchanges. We support the Proposal and commend the Commission for its deliberate consideration of pre-routing display functionality. GETCO has consistently opposed flash order types, in both the equities and options markets, and submitted a June 4, 2009 letter outlining our views in response to rule filings by two exchanges seeking to implement flash orders in their markets.[2]

Exchanges should be free to implement incentive models they believe are best for their members and customers, so long as those models are consistent with the fundamental components of our national market system -- transparency, price discovery, equal access, and above all, vigorous price competition. Flash and step-up orders are at odds with these goals and should be prohibited.

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1 GETCO, with offices in Chicago, New York, London and Singapore is a privately-held, electronic trading firm that provides liquidity to exchanges and Alternative Trading Systems ("ATSs") in the US, Europe and Asia. GETCO, an early entrant in electronic trading, utilizes automated trading models to trade on various exchanges and ATSs. GETCO is a registered market maker on various equity exchanges including Nasdaq, BATS and NYSE Arca.

2 *See* Letter to Elizabeth Murphy, Secretary, Securities and Exchange Commission, regarding SR-NASDAQ-2009-043 ("Flash Order"); BATS SR-BATS-2009-14 ("Bolt Order"); Direct Edge ECN's ELP Program (June 4, 2009). After receiving Commission approval to implement flash orders, BATS and Nasdaq voluntarily discontinued offering these programs in September 2009.

II. Reasons the SEC Should Ban Flash/Step-Ups in Equity Markets and Listed Options Markets

1. Creation of Two-Tiered Markets

Allowing exchanges to display marketable orders to its members that lock better-priced orders on other exchanges, through that exchange's own private data feed, rather than being immediately routed or displayed to the entire market could lead to a two-tiered market structure. The Commission has previously determined that the development of two-tiered securities markets is harmful to investors, particularly retail investors.[3]

2. Best Execution Concerns

Although an order-routing firm will often pay less in fees by utilizing a step-up process, doing so can often result in inferior executions for customer orders because the NBBO can worsen (i.e., a customer may miss the market) during the display period. Many customers, including retail investors, may not be fully aware that they receive worse executions so that their routing broker-dealer can reduce its execution costs. Furthermore, although some investors may accept this trade-off, GETCO believes that there is little regulatory oversight of these trading practices, both with respect to best execution and front running by step-up order recipients.[4]

3. Wider Spreads

Flash and step-up orders allow market participants to leverage a competing exchange's displayed liquidity without necessarily routing orders to the better prices. Through the public posting of orders, liquidity providers supply valuable information to the market. The proliferation of step-up order functionality, however, will discourage market participants from displaying liquidity at better prices because they will increasingly not be rewarded with an execution. This will, in turn, decrease competition among liquidity providers and eventually lead to wider public spreads. As spreads widen, internalization will increase, ultimately harming investors who are not part of the step-up network, particularly retail investors.

III. Step-Ups in Options Markets Inhibit Price Competition

The debate over step-ups in the listed options market is fundamentally about the value of competition in our markets. Ostensibly, price competition should be intense in the options markets given the fact that customer orders cannot be executed off-exchange and

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3 *See, e.g.,* Securities Exchange Act Release No. 34-41297 (December 8, 1998), 63 FR 70844 (December 22, 1998).

4 GETCO is also concerned that important order information is not captured thereby making it difficult for regulators to reliably identify instances in which violative conduct occurs. Best execution and front-running surveillance would require information that is currently unavailable in existing order audit trail data (i.e., "OATS" data).

must be exposed to competition among market makers on each exchange. Unfortunately, price competition appears to be all but irrelevant on most traditional options exchanges today. Exchange collected and specialist controlled payment for order flow monies make it very difficult for market makers to compete with the specialist on price. As a result, options investors do not, in our opinion, benefit from intense price competition that is prevalent in today's equities markets. Most retail options orders are internalized; that is, routed to the exchange based upon payment for order flow arrangements rather than upon execution quality or displayed best price. Step-ups reinforce the opaque options market system of payment for order flow that benefits exchanges, retail order-routing brokers and exchange specialists without necessarily benefitting retail customers. Eliminating step-ups recognizes how the practice -- like flash -- inhibits vigorous price competition around liquidity provision and can expose retail customers to worse executions.

While some market participants assert that differences between the equities and options markets may warrant different conclusions with respect to pre-routing display functionality on those markets, such arguments are misplaced. There is no compelling reason for different treatment between flash programs in equities and step-up programs in options. Both markets have significant retail investor participation, and both markets are highly automated. Moreover, as discussed above, the policy implications are similar, if not identical, for trading on the equities exchanges or the options exchanges.

IV. The Link between Step-Up and Payment for Order Flow

One significant difference between the equities and options markets is the close relationship between step-up and payment for order flow programs on the options markets. Competitive prices on maker-taker exchanges have threatened the traditional options exchanges that sponsor payments for order flow programs by pressuring the economics of the payment for order flow model. When payment for order flow specialists route orders away to a maker-taker exchange displaying better prices, they lose out in several respects: (1) they miss making profits from executing on those trades; (2) they pay "taker" fees for routing those orders to quotes on the better market; and (3) they often make payment for order flow payments to retail options brokers for the retail orders pursuant to their private agreements.

Not surprisingly, there is a strong desire among payment for order flow specialists to avoid routing orders away to maker-taker exchanges. In response, traditional options exchanges implemented step-up programs that provided preferential treatment for their own market participants and attempt to restore the necessary economics to allow the payment for order flow system to continue.

V. Step-Ups in Manual and Electronic Markets

Step-up advocates often assert that "step-ups have always been used in options markets." When markets were manual, it was routine for a specialist or market maker to announce to the crowd that there was an order on the book that would be "routed away" if a crowd member didn't "step-up" to trade against that order. Step-up proponents mistakenly assume that the potential benefits associated with step-ups in a manual market automatically apply in an electronic market, which is simply not the case. As we noted in our June 4 comment letter, step-ups were created in a bygone era and no longer provide any tangible benefits to investors:

> The market structure components of a "step-up" process are borrowed from a traditional floor-based practice that is no longer applicable in today's electronic markets. In the floor based trading environment, a customer order was represented to the crowd for either price improvement or to save the broker-dealer representing the order the latency and opportunity cost of routing the order to an away market center. In that instance, if an order had a three second exposure in which to allow participants of that particular market center to "step up" and execute against it, there was the potential to save a 1-minute delay because the order may not need to be routed as a result of the step-up. This type of scenario seems to be a justifiable trade-off between rewarding those that publicly display liquidity and a market center's ability to leverage an away market's public quotation to execute a customer's order at a better price and in a timelier fashion.
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> In today's electronic markets, however, vigorous competition has resulted in technology improvements that have dramatically reduced the amount of time it takes to access an away market. Most major exchanges can be accessed in single digit milliseconds, and will likely get faster. As such, allowing a "step-up" display period of 500 milliseconds [or longer] does not provide the same benefit as the traditional floor based model and may only cause customers to "miss the market" because of the "step up" process.

VI. Maker-Taker Pricing Contributes to Vigorous Inter-Market Price Competition

Step-up supporters also suggest that these order types are necessary to protect broker dealers and market makers from paying "taker fees" on maker taker exchanges, which they claim are passed on to retail investors in the form of higher commissions. Taker fees are linked to rebates or maker fees paid to liquidity providers. Step-up proponents imply that maker taker exchanges allow market makers to make better prices and earn more money than specialists on payment for order flow exchanges by virtue of the rebate they offer to liquidity providers. Rebates clearly can help market makers quote better prices; however, rebates alone do not equate to more profitable trading strategies. Market makers simply factor rebate amounts into their valuation of the subject security, thus allowing them to quote better prices (i.e., a smaller spread).

Even with a higher take fee, a consumer of liquidity on a maker-taker exchange is more than compensated by the effects of receiving executions at better quoted prices. For example, a market with maker taker pricing for options series XYZ may be quoted at $2.49 x $2.50, while a traditional options market without maker taker pricing will be quoting $2.49 x $2.51 (i.e., a wider spread). If an investor sends in a market buy order of 10 contracts, and the order is routed to a maker-taker exchange, the total cost will be $2,504.50 (10 x $2.50 x 100 + $.45 per contract).

Step-up proponents contend that by allowing the order to be flashed on a payment for order flow exchange, a market maker can "step-up" and match that price, thus saving the routing firm the $.45 per contract. While it is true that the routing firm will sometimes avoid paying the $.45 taker fee and can ostensibly keep commissions lower for their customers, step-up supporters ignore the reality that in the absence of competitive forces created by maker-taker exchanges the routing firm's customers (i.e., the retail investors) ultimately end up paying $0.55 more per contract on a payment for order flow exchange, because the spreads are wider without an incentive to quote better markets in the form of competition amongst liquidity providers. In this example, the investor pays $5.50 more. ($2.51 x 10 x 100 or $2,510).

Furthermore, maker taker pricing is transparent and applies in a much more uniform manner to all market participants. Any participant who adds liquidity receives a rebate payment and any participant who consumes liquidity pays a taker fee, regardless of whether the participant is a market maker, retail investor, or institution. Conversely, a payment for order flow pricing structure is far less transparent. Whenever a market maker trades with a customer the exchange will collect a fee that is aggregated and allocated to certain customers at the sole discretion of specialists according to their individual business interests. This opaque pricing scheme creates a situation where some retail brokers may receive payment for order flow, while others may not.

VII. Options to Safeguard Investors

While GETCO supports treating step-up in options in the same manner as flash in equities, and believes all such practices should be banned by the Commission if the step-up must be preserved to safeguard the payment for order flow model, it should be amended in order to safeguard the rights of the retail investor. Below are possible revisions which would help minimize execution risks:

- Guarantee the NBBO of the away exchange that the auction is trying to match.
- Disseminate the locking order on OPRA for all to see and access.
- Allow all classes of market participants to equally compete in the step-up auction, including customers, non-market makers and market makers.
- Allow customers real choice at the time of order entry if they want to opt into the flash process rather than accepting an immediate fill. Add a disclaimer if the agent is making the choice on their behalf.

VIII. Conclusion

The emergence and proliferation of pre-routing display functionality to a select class of market participants raises numerous market structure concerns, including fair access to information; fostering vigorous competition among participants; promoting transparency of information; and supplying incentives to market participants to publicly display limit orders. GETCO respectfully urges the Commission to amend Rule 602 of Regulation NMS to eliminate the exception for the use of flash order functionality by equity and options exchanges.

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GETCO appreciates the opportunity to submit these comments. Please do not hesitate to contact me at (312) 242-4600 if you have any questions regarding this letter.

Sincerely,

John A. McCarthy
General Counsel

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
Robert W. Cook, Director, Division of Trading and Markets
James Brigagliano, Co-Acting Director, Division of Trading and Markets
Daniel M. Gallagher, Co-Acting Director, Division of Trading and Markets