SIFMA

Securities Industry and Financial Markets Association

December 1, 2009

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F St., 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 request for comments as to whether flash orders should be banned in the listed options markets and the extent to which manual trading floors in the options markets might have continued need for reliance on the flash order exception. The Committee's comments are limited to the use of flash orders in the options markets, and thus we do not take a position in this letter with respect to the Commission's proposal to ban flash orders in the equity markets.

The Committee appreciates that our industry has experienced in the past two years substantial adverse economic events, a significant increase in market volatility, and a decrease in investor confidence in the markets. We support the Commission's study of these events and consideration of whether existing regulations need to be fine-tuned and whether any new regulations are necessary. We also recognize the Commission's stated "responsibility to uphold the interests of long-term investors" when they conflict with the interests of short-term traders.[3] We similarly have investors' interests in mind and a desire to find the right regulatory approaches to prevent a recurrence of such economic upheaval. We therefore welcome the opportunity to provide comments on the current proposal to ban flash orders

[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] *Id.* at 48636, n. 44.

as it applies to the options markets, and to work with all market participants to ensure that any new regulations will address any particular problems at hand and do not inadvertently harm the markets or investors' interests in the long run.

We recognize that it is often difficult to strike the perfect balance in this regard, but we hope that our comments below contribute to this effort. As the Commission has acknowledged, flash orders have clear beneficial effects in the markets.[4] Accordingly, any policy decision as to whether or not to ban flash orders must balance the known benefits of flash orders to investors against the perceived negative effects. By providing background as to the long-standing use of flash orders, sometimes referred to as "step-up" orders, in the options markets, by distinguishing the ways in which options markets operate differently from the equity markets, and by explaining the reasons why the use of flash orders is still beneficial in the options markets, we hope to demonstrate why these orders continue to have a purpose in the options markets and do not have a negative impact on the markets or options investors. In fact, the Committee believes that their removal would cause harm to long-term options investors, and that flash orders should thus remain as an important tool in providing such investors, especially retail investors, with the best possible order execution at the lowest cost. Particularly in view of the absence of empirical data to date demonstrating that flash orders cause harm to options investors, the Committee believes that the balance is in favor of the continued use of flash orders in the options markets. The Committee further believes that any concerns regarding potential abusive use of flash orders should be addressed instead through rigorous surveillance programs and appropriate regulation sufficient to identify and punish such abusive conduct.

<u>Options Markets Structured Differently From Equity Markets</u>

Under the Commission's Regulation NMS, customer orders must generally be executed at a price no less favorable than the national best bid or offer ("NBBO"). If the market on which an order is held is not at the NBBO, the market must either match the NBBO or route the order to the market displaying the NBBO. There are certain structural differences in the way that the equity markets and options markets meet these obligations, and not all of the provisions of Regulation NMS apply to the options markets.

Many equity markets employ what is referred to as a "maker-taker" fee structure in which orders that "take" liquidity by executing against displayed quotations are typically charged a fee, whereas "resting orders" that provide liquidity and establish the NBBO may earn a fee. When customer orders are routed from one equity market to another, there may be a routing fee that is passed on to the customer.

While some options markets also charge maker-taker fees, most options markets continue to follow a model (sometimes called the "traditional model") in which customer orders are executed without liquidity charges, and in which any routing fees charged by the destination market are absorbed by the market transmitting the order. In the traditional model, if the market holding the order is not displaying the NBBO, the market will provide an opportunity for other market participants to "step-up" and execute the order at a price as good as or better than the NBBO before the order is routed to the away market. Orders

[4] *Id.* at 48637.

subject to this procedure, which are now often referred to as "flash orders," have long been used in the options markets. Automated flash orders in some form have been in use since at least 2004. The International Securities Exchange, LLC ("ISE") estimates that over 80% of options trading takes place on traditional exchanges.[5] The options market is quote driven and the majority of displayed quotations are submitted by professional liquidity providers as opposed to long-term retail investors.[6] Furthermore, unlike the equity markets in which professional firms submit marketable orders into the flash system to earn a rebate, the options markets do not offer rebates, eliminating any potential motivation to flash orders purely for the opportunity to receive a rebate.[7] Finally, an options exchange may only flash orders that are marketable.[8]

<u>Benefits of Flash Orders in Options Markets</u>

<u>Price Improvement</u>. Flash orders allow customers to choose to have their orders exposed for a very brief period of time to potential undisplayed trading interest in the market on which the order was submitted. As an example, the Chicago Board Options Exchange ("CBOE") exposes its flash orders for only 150 milliseconds. This allows other market participants to "step-up" to execute the trade on terms more favorable to the customer, thus providing the customer the opportunity of "price improvement," *i.e.,* the opportunity for the order to be executed at a better price than the NBBO.[9] In addition, the CBOE noted that in August 2009, it executed "…2.2 million contracts through flash trading while only 842,000 contracts were disseminated by all exchanges in connection with those flashes,"[10] indicating that flash orders provided 1.3 million contracts of additional liquidity to CBOE customers. The benefit to the investor is obvious. If flash orders are banned, a customer's marketable order will either be executed against the best bid or offer on the exchange or, if the best price is available only on another market, the order must be routed to the other market. However, there is no guarantee that, in the time it takes to route an order, orders will receive the best price or that orders exceeding the size displayed on another market will be filled at the displayed price.

Flash orders permit price improvement by giving investors access to undisplayed trading interest. Market participants may reasonably determine not to publicly display their best prices in today's rapidly moving markets due to concerns that a market participant would be unable to update a quote quickly enough to prevent traders from trading against the posted quote.[11] This is particularly true in the options markets because of the increased difficulty of updating quotations in multiple series of options on the same underlying security, increasing the risk that a trader may trade against a still-displayed stale price. The Commission has recognized this benefit of flash orders, noting that "…the flash mechanism may attract additional liquidity from market participants who would not be willing to display their

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[5] *See* "Market Share" at http://www.ise.com/WebForm/volume_statistics.aspx?categoryId=482
[6] *See* letter submitted by CBOE in File No. S7-21-09 (November 18, 2009), p. 1.
[7] *Id.* at 10.
[8] *Id.* at 3.
[9] International Securities Exchange, LLC ("ISE") Position Paper on Flash Orders in the U.S. Options Markets at 3 (August 2009), *available at* http://www.ise.com/assets/files//ISE_Position_Paper_on_Flash_Website.pdf
[10] *See* File No. S7-21-09 at 6.
[11] *Id.* at 3.

trading interest publicly," and accordingly may allow for better execution than re-routing such trading interest elsewhere with no guarantee that these would obtain an execution.[12]

Size Improvement. Orders exceeding the size available at the NBBO may particularly benefit from the use of flash orders, as flash orders may draw out additional liquidity necessary to fill the order immediately at a better price, rather than, as ISE notes, resorting to "…'walking the book' to fill…[the] order at increasingly inferior prices."[13] In other words, the number of contracts that can be executed at the NBBO may actually be greater on the original exchange.

Faster Execution. Flash orders also provide market participants with more timely executions by diminishing the need to re-route orders.[14] They increase the likelihood that an execution will occur in the market in which the order was entered.

Flash Orders Primarily Benefit Retail Investors. CBOE indicates that users posting at the NBBO are overwhelmingly professional market makers and not long-term retail investors, and users submitting flash orders are overwhelmingly long-term retail investors, suggesting that long-term retail investors benefit most from price improvement mechanisms.[15] Data show that the median size of flash orders on CBOE, for example, is only eight contracts. While only a very limited percentage of orders are flashed, the practice is nevertheless important to the competitiveness of the markets.[16] Retail options customers access price improvement through a number of specific programs such as the Price Improvement Period Program ("PIP"), Price Improvement Mechanism ("PIM"), and Automated Improvement Mechanism ("AIM") programs used by the Boston Options Exchange, ISE, and CBOE, respectively. Orders submitted in these programs are generally guaranteed by the firm submitting the order (the "sponsor") to be filled at the price at which they are submitted, if not better. While the Commission has indicated that it preliminarily believes the status of price improvement auctions such as PIP, PIM and AIM would not be altered by the elimination of the flash order exception,[17] the Committee is concerned as to how this result would be brought about. The Committee believes that all current price improvement mechanisms (including PIP, PIM and AIM) currently rely on the exception the Proposal seeks to repeal. The Committee emphasizes the importance of price improvement auctions in the options marketplace and urges the Commission to ensure that programs such as PIP, PIM and AIM would be unaffected should the Commission effectuate a ban on other flash orders. Even if these programs are preserved, however, not all customer orders can take advantage of them. For other retail orders that must be executed through automated systems, the only practical opportunity currently available for price improvement is through flash order processes such as the Hybrid Agency Liaison mechanism operated by CBOE which automates the handling of orders received when CBOE is not at the NBBO. The Committee believes that the elimination of such programs would impose substantial

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[12] *See* Release No. 34-60684 at 48637.
[13] ***See*** ISE Position Paper on Flash Orders in the U.S. Options Markets at 3.
[14] ***Id.*** at 4.
[15] ***Id.*** at 4.
[16] ***See, for example,*** File No. S7-21-09 at 3, which notes that CBOE constitutes the NBBO 90% of the time. This ability to match is especially attractive to retail brokerage firms, as their orders may be executed at NBBO without paying significant execution fees to maker-taker exchanges, which may be as high as $0.45 per contract.
[17] *See* Release No. 34-60684 at 48638.

monetary losses on investors, particularly retail investors. Accordingly, the Committee believes that the flash order exception should be preserved for all such orders in the options markets.

Reduced Trading Costs. Flash orders also benefit investors by reducing trading costs, as they allow order entry firms to fill options orders internally and avoid potentially significant access fees levied by other markets.[18] Options markets do not charge fees, or charge minimal fees, for market participants using flash orders. However, markets do charge fees to access displayed quotations. The Commission estimates that the average access fee for displayed quotations if the flash order ban is adopted would result in an approximate total cost of $13,309,429 on a yearly basis in increased fees for all investors, representing an increase that is twenty times greater than the average access fees for executed flash orders in the options markets.[19]

The Committee believes that the Commission's estimate significantly understates the potential harm because it does not take into consideration the likely implementation of routing charges as a response to the ban on flash orders. Such charges, which are common in the equity markets, are potentially more harmful in the options markets due to the ***lack of any pricing cap on transaction fees in the options markets***. Rule 610 of Regulation NMS currently imposes fee caps only on equity markets for the execution of orders in the marketplace.[20] The Committee is concerned that the potential elimination of price improvement programs and the absence of fee caps in the options market would significantly increase costs and reduce the opportunity for investors to receive the price improvement currently available to them.

An additional disadvantage of these increased fees in the options markets stems from the fact that options prices are derived from prices of the underlying assets using pricing formulas. As transaction costs and routing fees are not taken into account in current pricing formulas, increased fees may impair the usefulness of these formulas.

Lack of Empirical Data Showing Negative Effects of Flash Orders in the Options Markets

The Commission has expressed concern respecting the potential adverse effects of flash orders on investors by removing incentives for market participants to publicly display trading interest thus reducing quote competition, diverting marketable order flow from displayed markets, and limiting market information to select groups of investors to the disadvantage of others.[21] The Committee believes that these alleged negative effects have not been shown to exist in the options markets, and that, to the extent specific abuses are identified, they are better addressed through surveillance than by prohibiting all flash orders.

[18] *See* ISE Position Paper on Flash Orders in the U.S. Options Markets at 4.
[19] *See* Release No. 34-60684 at 48637-8 and 48643.
[20] The Commission has noted its ongoing consideration of a petition requesting the imposition of a pricing cap on certain transaction fees in options markets. *See* Release No. 34-60711 at n. 49 (September 23, 2009).
[21] *See* Release No. 34-60684 at 48636.

Flash Orders Have Not Harmed Quote Competition. The Committee is not aware of any evidence that flash orders have impaired quoting activity in the options markets. During the time that flash orders have been available in the options markets, the number of competitive options markets has grown from four to seven, and published reports indicate that at least three new exchanges are expected to enter the options markets in 2010.[22] Indeed, there has been exponential growth of the options markets in recent years and consequently increased quoting activity. Data suggest an increase in bid and offer size as well, and some market participants believe that flash orders actually increase quote competition by forcing market participants to quote more aggressively to avoid losing executions to flash orders. Some options exchanges deploy maker-taker markets and automatically route marketable orders to a market displaying the NBBO if they cannot be filled on that exchange. Those exchanges continue to compete successfully with exchanges permitting flash orders. It appears that different market structures may appeal to different types of investors, and options markets may 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. This is healthy competition that should not be suppressed by a ban on flash orders in the options markets. Again, we maintain that, if there is any malfeasance in this area, it can and should be detected through other regulatory or supervisory means.

It is also worth noting, as mentioned in the CBOE letter, that displayed quotations in the options markets are overwhelmingly made by market professionals and not long term investors. These are to a significant degree the same entities who respond to flash orders. Protecting their quotations against competition from flash orders is thus unnecessary. Moreover, because options pricing is to a large degree derivative of pricing in the markets for the underlying interests, the importance of protecting the advantage of the first quoter to change a price is much less than in the equities markets.

Finally, despite the long-standing use of step-up procedures including automated flash orders, it is still the case that only a relatively small percentage of orders are executed in this way. By the Commission's own estimate, the total volume of flash orders in listed options that received an execution during the flash process during a recent month was only about 2% of the total trading volume.[23] At that level, it is difficult to understand how flash orders could be a significant disincentive to quoting activity.

No Two-Tiered Market Problem. The Commission has also expressed concern that flash orders create a two-tiered market in which the public does not have access to information and to opportunities made available to more sophisticated investors.[24] The Committee notes that flash orders act as a mechanism for price discovery, as many options markets make flash order data available free of charge to all options market participants and permit anyone to act on flash orders. While it is true that investors require sophisticated software to respond to flash orders, no such technology is required to submit orders to the flash process. It is not reasonable to describe this as a two-tiered market. Given the obvious benefits of flash

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[22] Securities Industry News, PHLX Veterans Plan New Venue in Crowded Options Market, April 27, 2009, http://www.securitiesindustry.com/issues/19_93/-23402-1.html
[23] *See* Release No. 34-60684 at 48643.
[24] *Id.* at 48636.

orders to investors, including long term retail investors, flash orders should not be banned unless there is evidence of harm. Specialists and market-makers often have an informational advantage, but their trading activities are subject to rules imposing affirmative obligations to trade in the interest of fair and orderly markets and are subject to surveillance by the exchanges. Furthermore, as the Commission notes, flash orders are voluntary, and consequently investors are free to determine whether or not to use flash orders.[25]

Misuse of Market Information. The Commission has expressed concern that market participants with access to flash order information might be able to trade on that information to the detriment of the investor placing the order—*i.e.,* engage in a form of front running.[26] The Committee is aware of no evidence that flash order data is being abused or lends itself to abuse in this way. An investor's use of flash orders is voluntary, and investors who believe that they expose themselves to harm by submitting such orders are not required to do so.

Nevertheless, it makes sense to require that the exchanges permitting flash orders monitor for such abuses, if for no other reason than to provide confidence that there are none. Flash orders create electronic audit trails that facilitate rigorous surveillance.[27] Targeted surveillance programs to monitor for abusive behavior are a much more appropriate response than implementing a broad ban on a market program that has brought significant benefits to investors in the options markets with no clear evidence of investor harm.

Locking and Crossing Quotations. The Commission has expressed a concern that marketable flash orders may undermine the provisions of the Options Linkage Plan, which includes a prohibition on the practice of displaying locking or crossing quotations that is analogous to the prohibition of Rule 610(d) of Regulation NMS.[28] There is debate as to the desirability of the prohibition of Rule 610(d).[29] Whatever the merits of that debate, the Committee does not believe that flashing an order in expectation of achieving execution at a better price is equivalent to displaying an order that causes a locked market. As noted above, the options markets have long provided opportunities for price improvement through step-up procedures, and we know of no reason that these procedures should now be perceived as in conflict with the policies of Rule 610(d) despite their previously-explained benefits for investors.

Impact on Manual Trading Floors If Flash Order Exception Is Eliminated

The Commission also has requested comment on the continued need for a flash order exception with respect to manual trading floors operated by the options exchanges. The Committee believes that a prohibition against all forms of flash orders would prohibit or negatively affect manual floor trading. Should the Commission impose a ban on flash orders, the Committee urges the Commission to preserve an exemption for manual trading floors sufficient to avoid impairing these markets.

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[25] *Id.* at 48637.
[26] *Id.*
[27] ISE Position Paper on Flash Orders in the U.S. Options Markets at 4.
[28] *See* Release No. 34-60684, n. 51.
[29] *See* File No. S7-21-09 at 7.

Exchange floor brokers often have the discretion to purchase or sell options at the best available price, regardless of where that price may be obtained. They have a responsibility to achieve best execution for customer orders that they represent. They must factor in price, liquidity, and timeliness of execution. The ability to "match" an away market is essential to achieving best execution. A floor broker's ability to "work" an order to achieve a superior execution for a customer is one of the most important reasons that some customers direct orders to the trading floor. A prohibition against any sharing of order information on the trading floor would be detrimental to the execution of that order and to the auction process in general.

As noted in the Proposal, the current exception to Rule 602 for manual trading floors "…was intended to facilitate manual trading…by excluding quotations that were considered 'ephemeral' and impractical to include in the consolidated quotation data."[30] The rationale for approving this exception for manual trading floors has not changed despite the fact that automated markets began disseminating similar information electronically with a much shorter duration than the 'ephemeral' manual quotations. The Commission's stated concerns about flash orders appears to relate primarily or exclusively to highly automated trading environments. The Committee therefore believes that the Commission should preserve the flash order exemption for the manual trading floors to which it was originally intended to apply. If the Commission nevertheless determines to eliminate the flash order exemption, it should in doing so make very clear that it does not interpret Rule 602 as so amended to prohibit existing practices on manual trading floors. While such an interpretation may be possible, the Committee would prefer that the exemption not be deleted in the first place, eliminating any opportunity for confusion that might be caused by such interpretations.

The Committee strongly believes that flash orders in the options markets provide options investors, especially retail investors, with numerous benefits as described above and that such benefits outweigh any potential negative effects. We have not seen any empirical data to date to support the notion that flash orders have a negative effect on the options markets, diminish quoting activity, advantage short-term traders or "insiders" at the expense of retail customers, deprive investors of important market information or otherwise create harm to options investors. The Committee supports measures to identify and curtail any negative effects or abuses that may result from the use of flash orders and urges the Commission to address any such issues by considering the adoption of robust surveillance programs and other regulatory means to monitor any potential negative effects. The Committee believes that instituting a broad ban on flash orders in the options market would not only deprive investors of the many benefits of flash orders, but also would likely have unintended adverse consequences on the markets and investors, such as significantly increasing transaction costs.

[30] *See* Release No. 34-60684 at 48632.

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 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.

Sincerely,

Thomas F. Price

Thomas F. Price
Managing Director

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
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