November 23, 2009

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission

Comment on Release S7-21-09

Dear Ms. Murphy:

I am pleased to comment on your proposed elimination of the Flash Order Exemption from Rule 602 of Regulation NMS. As a former options market-maker, Acting Chairman of the Pacific Stock Exchange and owner-operator of the boutique options clearing firm Sage Clearing Corporation, I have been interested over the span of 30 years in the evolving SEC perspective on market structure, particularly in the options trading industry in the United States. I applaud the goal that the Commission continues to strive for in recognizing the need for incentives for options market-makers who continue to be the source of liquidity for the hundreds of thousands of quotes they provide every second in our quote driven system which is the basis for the most successful options market in the world.

However, I believe that the proposal to ban flash orders needs to distinguish between the equities and the options markets, as the impact of the flash order rule change will have much more significant impact in the options industry than in the equities industry. There are two significant differences between options and equities trading that merit consideration - first, options pricing is derivative - therefore dependent on not only the underlying price and liquidity of the stock, but also the prices and liquidity of options on the same equity in other months and strike prices. Therefore, an options quotation by a market-maker is significantly more complicated than one by an equities specialist or market-maker. The quotation for any given options order can be impacted by the presence of other resting options orders and their size, and the accessibility of those orders to a market-maker. The perfect system for price competition for customers would be an electronic auction system operated on a central exchange with access open to all participants in the business.

However, the Commission has determined that the competing exchange model is in the best interests of the investing public by offering different types of priority, fees, rebates, service, speed and at the same time trying to encourage price competition between exchanges. In doing so, the Commission has made compromises to the ultimate goal of price competition; for example, the best method for insuring that the public customer gets the best price among competing exchanges is to require that the broker that controls the order send that order to the market displaying the best price. Instead of adopting a rule that would encourage options market-makers to always display their best price, the Commission has instead put the burden of insuring best execution on the brokers handling the order.

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The Commission's compromises have resulted in robust competition among the options exchanges, with two different models for customers and firms to choose from - the traditional customer protection and no customer fee model versus the maker/taker model. The flash order functionality operated by the options exchanges are their own compromise to developing trading mechanisms to insure best execution for their customers while retaining the economics of having order flow directed to their exchanges.

I believe that the Commission must ask itself whether the perceived negatives about flash orders ("free looks" or "last-mover" disincentives, potential frontrunning issues and a "two-tier" market) are any worse for public confidence in the markets than the decisions the Commission have already made, such as to not require a central limit order book, "CLOB", where public customer orders would always be executed ahead of any others, or a requirement for broker routing to the best publically displayed markets where there can be no question about the possible conflicts of payment for order flow, or internalization. Under both of those situations, there would be no need for flash orders of marketable orders of the public.

Should the Commission decide that action is needed on flash orders is needed, I would hope that the Commission will pass a rule that allow flexibility in applying the exemption from Rule 602 so that the options exchanges can develop modified rules to deal with marketable orders. For example:

1. Allow a broker to send a marketable order to an options exchange that is not displaying a price equal to the NBBO for the purpose of using a flash mechanism to ask for a market in the option without revealing the side of the order or its size. ("Requesting a flash market"). Exchange participants must respond to such a flash market request with a two-sided market at the NBBO or better in order to interact with such order and any improvement in their bids/offers must be reflected in the public quote of that exchange during the flash period.

I do believe that such a rule could improve market center competition without totally eliminating the use of flash, but putting limitations on its use. First, the issue of the "free look" at orders (described by the Commission as the "last-mover advantage over displayed orders"...) is addressed as now the respondents to the flash orders must post their bids/offers prior to the details (price, side and size) of the flash being revealed. Secondly, such a rule will improve market liquidity as it requires that flash respondents post competitive bid/offers in order to be eligible to participate in the execution of the order.

It is true that under this rule sophisticated systems run by automated market makers might "guess" the side of certain orders, but certainly not their size, particularly when the NBBO is at the minimum spread when the flash market is requested. However, under this rule at least some of the information advantage has been reduced in the flash order process and it also raises the risk for respondents by requiring them to post a two-sided market rather than just being able to step up only on one side of the market.

This process replicates how market, or marketable orders, had been handled on the floors of the options exchanges for many years by the floor brokers representing public orders. The broker would usually try and find a better bid or offer between the markets in order to achieve price improvement after calling for a two sided market; if the broker was unsuccessful, the bid or offer would be hit. Where there were competing markets in the options name, the broker could always ask for a bid/offer on the floor prior to routing away the order to the other exchange. For these reasons, I would think that the Commission would not wish to eliminate the exemption for "flash" orders as manually handled by a broker on the floor of the exchange as it will inhibit that broker's ability to improve the price of the order the broker is handling.

This alternative proposal may not fully address the concerns about the possibility of a "two-tier" system developing where public, nonprofessional participants do not have access to all the information in the market, as the proposal still allows flashing of market quote requests which is only available to persons at the exchange where a flash market is being asked for . However, in reality, members of the public have never had access to information about market or marketable orders or quotations in response to a request for markets.. Furthermore the Commission has determined that it is in the best interest of the markets to avoid "locked markets", when in fact locked markets is the best solution to this problem for members of the public as it would allow public participants to trade on full information with absolutely no spread to pay!

Nor has the Commission felt it important enough to require time-price priority, or public limit protection on all options exchanges that would "clearly uphold the interests of long-term investors", a goal of the NMS release. Mandating of a time-priority central limit order book across all exchanges for public non-professional investors certainly would be the greatest step for "fairness and efficiency" that the Commission desires for long-term investors. Yet the Commission has determined that the evolution of competing markets where public customers are protected from being traded through is sufficient, even while public customer limit orders at the top of the book are not filled.

In considering the flash order ban, the Commission must consider the risk in disadvantaging the one options exchange model that relies on not charging public customer fees which has made options trading affordable and competitive and which currently has 80% of all customer business. Rather than banning flash orders outright, the Commission needs to evaluate whether modifications to the current operation of flash in the options markets might be adopted to minimize potential damage to long-term investors while at the same time allowing the exchange business model that relies on flash to survive.

I urge the Commission to consider the alternative method of handling flash orders as I have proposed, and be creative in analyzing other alternatives to ameliorate the perception of unfairness and inefficiency so as to not undermine the options exchange models that have worked so well for serving the public customer.

Sincerely,

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President

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