SPIDERROCK

February 22, 2016

Via Email (rule-comments@sec.gov)
Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549-0609
Attention: Brent J. Fields, Secretary

Re: Proposed modifications of the Interpretation and Policy .01 to Rule 1.1(ggg) relating to Professionals – File No. SR-CBOE-2016-005

Ladies and Gentlemen:

We write in opposition to the CBOE rule change proposal and urges the Commission to disallow it because this specific rule change is not in the best interests of customers of the options markets. The proposed rule is anti-competitive and serves to enrich a small minority of firms at the expense of customers. As explained below, the modification will unfairly require the professional categorization of customers that are not market professionals and who do not compete with market makers, but who are rather simply trying to find counter-parties willing to trade inside of non-competitive market maker public quotes.

About SpiderRock

These comments are submitted by SpiderRock EXS, LLC and SpiderRock Advisors, LLC.

SpiderRock EXS is an agency broker and a FINRA member firm that operates execution algorithms for a variety of customers including hedge funds, proprietary trading firms, large bank trading desks, institutional advisors, wealth management firms, and other brokers and dealers. At present, SpiderRock EXS handles 1 to 2 percent of the typical daily listed options execution volume as advertised by the exchanges collectively.

SpiderRock Advisors is a federally registered advisor that acts as a sub-advisor implementing option based strategies in both retail and institutional accounts.

SpiderRock EXS and SpiderRock Advisors neither trade for their own accounts nor acts as a liquidity providers or market makers. Neither are members of any listed options exchange.

A brief overview of option market structure and dynamics

The U.S. listed options marketplace was originally and is still largely a quote driven market with designated and registered market makers that are principally responsible for providing public quotes acting alongside customers as well as firms trading for their own accounts who principally interact with the market by trading with market maker quotes.

Market makers, in these markets, enjoy several material advantages including preferential margin treatment and capital formation rules as well as enhanced book priority on certain exchanges. In addition, market makers are generally allowed to pay for, and control the routing of, customer order flow for the purpose of either maximizing or minimizing their own proprietary interactions on an order by order basis.

The listed options markets also allow non-market maker customers and firms to rest orders in exchange order books. These orders are then included, alongside market maker quotes, in the widely disseminated exchange price feeds. However, this type of customer market access is often restricted by various rules and technology barriers, including by the specific rule in question.

This market structure – i.e., the benefits given to market makers and the restrictions placed on other participants—mandates that sufficient competition remain in the quote formation process, if for no other reason than to ensure that customers, who may be restricted to only market *taking* and whose orders are being routed by the firms principally responsible for those same quotes, get a fair deal. Unfortunately, as explained below, this is, today, too often not the case.

Quote quality and competition

Today there are more option strikes quoted on more exchanges than ever before, around one million at last count. These markets, however, are wider today, by almost any measure, than they have been in either the recent or the distant past. There are likely several reasons for this deterioration in quote width but some leap to mind easily.

First, there has been a substantial increase, to alarming levels, of off-quote handling of otherwise marketable flow. This flow is either a) paid for and routed through market maker controlled routers which generally act to maximize the controlling market maker participation rate, b) preferenced to specific market makers on exchange, c) facilitated via various auction mechanisms, d) routed through complex order books, or e) handled in pre-exchange RFQ auctions and routed out as customer-to-customer matches.

These mechanisms are not quote competitive as they generally reward, minimally or not at all, the firm(s) that created and/or joined the NBBO markets that prevailed at the time. As such, they do not act to ensure tighter and more accurate quotes and instead free ride on the existing public quotes. At this time, more than 50% and perhaps as much as much as 90% of the marketable customer order flow (excluding proprietary products) in the industry is handled, at least in part, through these non-quote competitive mechanisms.

Secondly, and related, there has been a substantial decrease in the number of firms willing to post competitive public quotes. The primary reason for the decrease is that it is difficult to make a profit without broadly paying for order flow and participating in the pre-exchange order handling process. The "exhaust" or passed-over portion of the marketable order flow that does interact with public quotes is typically of marginal value. While the marketable flow that arrives directly is more than offset by the negative selection bias (propensity to get "picked-off" as the market makers would say) that results from being the public first mover.

Finally, there is little incentive for the paying market makers to post tight markets. After all, they are frequently controlling the routing of flow and they would prefer to route that flow into a wider rather than tighter market as that will maximize its value.

Today we believe that there are only three or four national market markers, all paying for order flow, and an uneven smattering of smaller firms actively posting what could be considered even marginally competitive quotes. This is down from a prior time in the industry when there may have been hundreds of quote competitive firms.

One observable consequence is the emergence, in a wide array of listed options markets that should be competitively quoted, of fairly wide “public” quotes coupled with a tighter “dark” quotes a few price variations inside. Improving the initial public quote by a single price variation will typically result in one to three of the quoters at the initial wider quote immediately following within in a few milliseconds. Improving a second time will also result in following behavior. Improving a third time may as well. At some point, when the tighter “dark” quote is reached this following behavior will stop. This routinely happens, whether buying or selling, and is a clear indication that the extant quoters are no longer really competing to put up their best inside markets.

Another observable consequence is the emergence of short duration pre- and on-exchange auctions mechanisms that allow firms to internalize orders from their customers. These auctions typically begin at prevailing NBBO prices and can, if there are competitive responses, result in customer receiving some price improvement. Unfortunately, we do not believe that these auctions are sufficiently competitive either. Most of these auctions are initiated by market makers who are also paying for order flow. On some exchanges, including the CBOE, auction responses are limited to market makers only and in general, across all exchanges, the number of competitive responses seems too low. While outside the scope of the rule change in question, we would ask the Commission to carefully review whether limiting auction responses to only a small number of market makers that are clearly demonstrating anti-competitive behavior in their quoting patterns is in the best interests of customers of these markets.

Almost the entirety of the SpiderRock customer base are users of these markets. They are attempting to build and hold positions, either long options or short options, in a wide variety of names, usually for weeks or months at a time. In general, they wish to build and manage their positions while paying their brokers and also market makers or liquidity providers as little as possible. While there is a willingness to pay a fair price for market making services, the extant group of market makers, with their obvious disdain for competitive quoting make it difficult to interact with the lit public markets simply by crossing markets and hitting bids or lifting offers. As a result, many SpiderRock customers seek alternative ways of interacting with the market and other market participants.

One such alternative involves posting “connected” or tied-to-underlyer orders at competitive levels on one side of the market, perhaps for somewhat extended periods of time, in hopes of finding a non-market maker counter-party.

Another popular alternative involves assembling a basket of orders (multiple underlyings; multiple expirations; multiple strikes) and, again in a connected fashion, increase the market competitiveness of the entire basket in a stepwise fashion until a sufficient number of strikes and quantity of options have traded.

Yet another alternative involves the use of complex orders or orders consisting of two or more legs, all with a single limit prices. These order types are popular primarily because they can be held out, much like connected orders, for extended time periods, without facing the detrimental effects of value drift.

Other alternatives are possible as well, however, they all have the same basic goal: interact with some counter-party inside the not very competitive public quotes.

Increasingly, these alternatives are resulting in SpiderRock customers being classified as professional customers rather than priority customers by virtue of the fact that they have, in effect, hired a more market savvy and technologically sophisticated firm to handle their interactions with the market.

For some SpiderRock clients, reclassification as a professional customer is a viable option, the primary impact being a modest increase in exchange fees. For others, particularly accounts where we manage overlays and other option based strategies, there is no option to do so. These accounts are with custodians, and in environments that simply will not support or allow the possibility of professional classification. As a result, we find ourselves advising clients to simply not trade options on underlyers that they would otherwise be willing to hold positions in due to the unavailability of competitive quotes. This, despite having the technical ability to enable these client orders to work in the marketplace in a manner that might allow them to discover a counterparty well inside the prevailing quotes.

Professional customer classification

Historically, option market customers have had the ability to post non-marketable limit orders in exchange order books, however; for many years, these orders were, almost exclusively, of the "disconnected" variety meaning they were not tied to the underlying that the option was written on and would not move in concert as their underlyer market price moved around. As a result, while their limit prices were fixed, their value drifted. If they drifted, in value, away from the market then market makers could freely ignore them. If they drifted toward or through markets then market makers could wait until they became obviously profitable before trading with them. Sometimes by getting out of the way until these disconnected orders drifted sufficiently through what should have been the competitive value level of the other side of the market.

The underlying markets themselves typically move around fast enough that these disconnected orders rarely occupy much time at the top of exchange order books and when they do, there is a good chance they will quickly either become profitable trading opportunities for someone else or drift away from top of book levels.

Over time, partly due to technology advances and partly due to the introduction of customer portfolio margining, a new generation of customer appeared that was able and willing to post "connected" orders into exchange order books that cancelled and replaced at new option premium levels in concert with underlyer movement. These new connected orders were generally not as good for the market makers as their disconnected predecessors had been. First, these connected orders would cancel and replace at new levels when their underlyer prices changed, just like the market maker quotes, without drifting to the point of becoming obviously profitable. Perhaps more importantly, however, these connected orders would spend more time on the top of exchange order books effectively competing with market markers for book position and allocation priority.

This new activity, particularly on exchanges with designated market makers, was viewed as detrimental to their business model and led to a series of attempts to curtail these new connected orders.

Logically, it would have been simplest, and in hindsight probably fairest, to have removed customer orders from their highest priority perch; however, it was and still is believed in the options community that the Commission would not allow this step without also requiring these same exchanges to forego their designated market makers as well.

In any event, the first attempt to fix this problem was the imposition of cancel fees on all customer orders to prevent them from being freely cancelled and replaced. This was, almost entirely, an attempt to bar connected orders. These cancel fees proved short-lived however and have now been abandoned. They simply were not very effective against the original intent, and were unpopular with customers and brokers unfamiliar with the listed options market structure.

In the meantime, one of the exchanges with designated market makers (ISE) attempted to cure the problems with cancel fees by focusing instead on the number of new orders submitted rather than the number of cancels tendered. The result was an exchange rule that forced brokers to classify their customers as either professional or priority based on the average number of new orders they submitted per day. The exchange chose the number 390, because there are 390 minutes in a trading day and they thought, at the time, that a reasonable retail customer would not generate more than one order a minute when typing into an order entry terminal.

Once classified as professional, a given customer would then lose priority in exchange order books and would no longer be eligible for automatic customer-to-customer matching in exchange auctions. Market makers that interacted with professional customer orders would no longer be required to pay a "marketing" or payment for order flow fee for the interaction. In addition, professional customers would generally face higher exchange fees.

This rule has had and continues to have some problems however. First, rather than base the order count on the number of orders submitted to the exchange, an approach easily audited by the exchange itself, the rule directed that all orders submitted by a customer to their broker should count for the purposes of the rule, even if their broker was not a member of the ISE and even if the orders in question were never routed to the ISE at all. In addition, the rule was vague about what should constitute an order. Should fuzzier discretionary or not-held orders be counted (such as orders that are handled by a high touch brokers or electronic execution algorithms) or only crisper exchange style orders? Finally, there is the question of whether it is appropriate for a single exchange (one of now fifteen) to define a category of customer classification for the industry as a whole. Moreover, what should be done when one exchange, for competitive reasons, came into conflict with others regarding classification?

After the Commission allowed this rule other exchanges with market maker models quickly followed and asked for superficially similar, but not identical, rules while the price time exchanges generally took little notice and did not, for a long time, bother to follow suit.

The initial versions of these professional customer rules, however, were relatively vague and did not adequately define or address the full complexity or range of questions which lead to subsequent rule changes and rule interpretation circulars being promulgated by a few of the individual exchanges.

As a result, the options industry was left with a bit of a conundrum. Some firms took the position that each exchange was defining what professional customer meant only on that individual exchange. As a result, a given customer could be classified as professional on one exchange and priority on another with the rules and interpretive guidance issued by a single exchange only applying to orders submitted to that exchange.

On the other hand, other firms took the position that they needed to somehow themselves harmonize these competitive rules themselves using a kind of least common denominator approach to determine how a given customer should be classified. Under this approach, a given customer would be classified in a uniform manner across exchanges; however, these harmonization attempts are uneven from one firm to the next.

Current controversy

One particular area of uncertainty in the professional customer landscape was the treatment of multi-legged or basket orders. Initially this was not much of a problem. However, over time a few firms, SpiderRock among them, took the position that a customer sending their broker a basket of strikes with some identifiable level of cohesiveness would constitute a single order for the purpose of the professional customer rule.

The CBOE informally agreed with this position. However, the prime brokers of some of SpiderRock's customers split on this question and, as a result, SpiderRock asked the CBOE to formalize their informal communication, which they did in the original filing of Rule 1.1(ggg). This, however, did not fully cure the problem as this CBOE rule filing was interpreted, in some compliance departments, as being in conflict with guidance from other options exchanges.

In any event, subsequent to the filing of Rule 1.1(ggg), a few of the national market making firms began pushing back on what they perceived to be an excess of customer-to-customer matching generally. This lobbying effort initially took form under the banner of the SIFMA listed options committee where a small group of national market makers and flow providers began an organized effort to approach the exchanges with specific guidance regarding the strengthening of the professional customer rules. The goal of this approach was and is to move additional customers from priority to professional range and thereby make them unable to be a party in customer-to-customer matches.

We feel that this effort is misguided. We do not believe that the problem today is, in fact, with the customers and firms who are effectively using connected orders, whether individually or in baskets. These order types are natural and increasingly popular in relatively wide and fragmented markets.

The core problem, rather, is with the priority customer classification itself, specifically with the notion that priority customer orders should automatically have highest priority in the exchange order books. This is an old rule from an era prior to the introduction of Regulation NMS, when the markets were entirely trading floor based and has now become an obstacle inhibiting fair and competitive markets.

For customers limited to disconnected order types, order book priority has only modest value and could easily be discarded or modified in a manner that would preserve most of the current benefit without creating an unfair advantage for connected customer orders that might be routinely joining existing market maker markets. One such modification, for example, would be to preserve priority only for customer orders that improve markets on arrival.

Speaking as an advisor with a fiduciary duty to our customers, we would be happy to give up automatic customer priority in exchange for being able to use connected and basket order types without restriction. We simply do not believe our customers' best interests are served by allowing them access to only immediately marketable or disconnected orders in wide markets of suspect competitiveness.

Conditional option basket orders

This rule modification, if allowed, will effectively eliminate priority customer access to conditional basket execution techniques. These techniques are currently available to customers, and, while relatively new and less well known, are becoming more popular. As they are new and not yet widely understood we will offer a simplified real world example of their use and rationale.

Suppose, by way of example, that we have been hired to implement an option overlay strategy in a customer account on a portfolio containing 50 underlyings, all with listed options. We would perform this service by using specific (automated, in fact) rules to determine suitable option strikes and expiration months for each underlying and then attempt to execute the required options at the best possible price for our customer.

Frequently there will be a number of strikes that meet our strategy requirements and while we are somewhat indifferent to the actual strikes traded we do have a target number of contracts for each underlying. As a result, we end up composing conditional execution baskets. Such baskets might contain 1 to 25 specific options series on each of 50 or so underlying securities for a total of perhaps 500 individual options series. We recognize that a 100% fill rate would be extraordinarily lucky and unlikely, so we do not reasonably expect that every order in all 500 series will get executed. However, we intend to execute at least one trade in at least one series for each of the 50 or so underlying securities.

In order to achieve efficient execution, we organize these orders into 50 or so distinct baskets, one for each underlying, and set both individual series size targets as well as basket size targets. We then set all 50 baskets and all 500 series to work in the marketplace simultaneously. We start each individual series at something close to our perception of a fair mid-market value and, over time, systematically improve the offered level of all series. As each individual basket size target is reached we cease attempting to execute additional contracts in that basket. When the overall set of 50 baskets has reached target size we are done. This order handling activity is automated and relatively easy to manage and might take place in a single afternoon or over the course of a few days. However, due to the overall number of options series, as well as the connected nature of the order handling it might result in the generation of 100,000 or more individual series option orders. Without either basket or connected order relief, this activity would promote the customer we are working for from priority to professional status, simply by virtue of having hired a more sophisticated advisor to manage the execution of an overlay strategy for them. If baskets are disallowed and connected orders remain, this same strategy would still result in 10,000 or more countable orders and would still result in promotion to professional status.

To be sure, we only engage in this kind of activity on exchanges and using specialized infrastructure and market access gateways suited to this purpose and not via the general purpose market access brokers and channels. Regardless, the rule change being proposed would effectively ban this style of order management activity in priority customer accounts of all types.

Customer account landscape

We would point out that at present there are well more than one million active customer accounts, both taxable and non-taxable, that can and, in many cases do, contain options traded in the listed options markets. Most of these accounts are held at large brokers with national scope. Some accounts are subject to Reg. T margin, others use portfolio margining. Some have beneficial owner(s) that meet certain wealth tests and other do not. Some account holders are do-it- yourself types that trade for their own account and others have hired an advisor or broker to act in their account on their behalf. Some are trading options to manage the expected risks and returns of a portfolio of core holdings while others are treating the options market as a form of casino where bets are made in rapid-fire fashion. Some have owners that are very knowledgeable about options and the markets they trade in while others are comparatively uninformed. Some trade infrequently, others trade frequently. Some execute trades exclusively through their primary broker and others higher one or more secondary, specialized, brokers to handle market interactions for them. In short, there are a diverse collection of customers trading options for a diverse collection of reasons with diverse levels of sophistication.

In this landscape, there is no agreed definition of "retail" customer, rather, there is a complex collection of accounts that can be categorized along a number of not-mutually-exclusive dimensions. Attempts to over-simplify this collection of accounts are not helpful and do a disservice to the customers themselves.

We would also point out that most of these accounts are housed with broker custodians that are not themselves CBOE trading permit holders (TPHs) and do not have direct access to CBOE or any listed options markets. When a customer of one of these brokers (or their advisor) submits an order for handling on the CBOE they do so by sending the order to the market via a specialized executing broker that is a CBOE TPH holder and frequently also a market maker on the CBOE and other exchanges as well. It is worth noting that these CBOE TPH holders do not have account relationships with and usually do not know the identity of the customers or advisors originating orders and would not, even in principle, be able to determine whether a given customer account had entered more than 390 order per day.

If the counting obligations under the proposed rule were to extend only to CBOE TPH holders then, as a practical matter, it would be impossible to determine whether or not the vast majority of accounts were, in fact, compliant. We would point out that CBOE does seem to be asking the Commission to extend their specific counting rules to non-member brokers, including SpiderRock EXS, that handle customer orders prior to sending them to a CBOE TPH holder. We do not feel that this supra-exchange authority is either authorized by the act or warranted and we do not welcome it.

Recommendations

We recommend that the Commission deny this rule filing as written. It is both convoluted and conceptually unsound. It will artificially restrict certain customers from the benefits of using conditional basket execution techniques. It will also bar use of connected order types for customers housed at a place and in a manner that will not support their promotion to professional status. Further, it will unfairly require the professional categorization of other customers that do not otherwise seem to be market professionals and are not systematically attempting to compete with market makers but are rather, simply trying to find counter-parties willing to trade inside of not-very-competitive public quotes.

We also recommend that the Commission no longer allow individual listed options exchanges to promulgate rules that have industry wide scope. There are now fifteen listed options exchanges. They actively compete among themselves, including in rule making. They, to varying degrees, cater to different and competing subsets of market participants. Moreover, we fear that some of the exchanges may be placing the best interests of their market makers ahead of our customers. As such, we would recommend that the Commission clarify that neither CBOE nor any of the individual options exchanges have the supra-exchange authority necessary to require enforcement of this and competing rules by non-exchange member firms. If the Commission believes this and related rules are in the best interest of customers we would request that professional customer rulemaking be moved to a more appropriate forum such as FINRA.

We recognize that competitive balance in a market this complex is a challenging topic and in the spirit of offering a solution, we would suggest a few simple, foundational, changes that could do much to improve the industry for the customer users of the markets and frankly, we feel, for the large majority of industry market participants as well.

First, we recommend that the Commission revisit the concept of customer priority and eliminate it. Among other things, this would substantially remove the rational for the split between priority and professional customer and could be the basis for recombining these classifications and removing their attendant complications all together.

For the exchanges without tiered allocation, this change would have no impact. For the exchanges with tiered allocations, it would return designated primary market makers, or perhaps market turners, to the highest perch with all other participants in secondary allocation tiers. However, a 40% guaranteed allocation for designated market makers is a large boon. If the Commission is going to continue to allow a single designated market maker to receive a guaranteed allocation of this nature then there should be an expectation that this market maker will make at least minimally meaningful markets, even and especially in names that are unlikely to trade. Returning to the old minimum width rules ($0.25 below $3.00, etc.) or something similar would be appropriate in this regard.

We would also recommend that the Commission begin phasing out market maker based payment for order flow, market maker order routing, and market maker preferencing. We believe that these practices seriously erode the competitiveness of the quote formation process. By no longer allowing individual market makers to directly pay for or route order marketable order flow themselves the Commission would be returning the industry to an environment in which competitive quoting would be genuinely rewarded and proper incentives returned to the market. This would also potentially eliminate a number of unseemly practices including the specter of a small number of national market makers paying for order flow that they then internalize based on quotes that they themselves are unwilling to make competitively.

Finally, we would ask the Commission to take notice of the fact that customers, both on their own and via specialized advisors and brokers, are becoming increasingly sophisticated and technology enabled and that predicating customer classification on the levels and kinds of activity that existed in prior eras may not be in the best interests of these same customers today.

If you would like to discuss this letter, please contact George Papa at [redacted].

Respectfully submitted,

SpiderRock EXS, LLC and SpiderRock Advisors, LLC