

Comment Letter CAT Funding Proposal

June 12, 2017

Via Electronic Mail - rule-comments@sec.gov

Mr. Brent J. Fields
Secretary Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File Number SR-CBOE-2017-040 Notice of Proposed Rule Change to Establish the Fees for the Consolidated Audit Trail

Dear Mr. Fields:

This letter is being submitted in response to the Securities and Exchange Commission's ("SEC" or "Commission") request for comments regarding the proposed Consolidated Audit Trail ("CAT") funding structure detailed in CBOE-2017-040. The CBOE and other US Exchanges and FINRA (collectively "SROs") that are Plan Participants in the CAT plan have proposed that 75% of the development and on-going costs of supporting the CAT be allocated to the broker-dealer community with the remaining 25% of costs to the SROs. For broker-dealers, the SROs have proposed a fee structure based on nine (9) pricing tiers; the underlying criteria for placement in a tier is based on electronic messaging traffic including quotes, orders and cancellations. Firms with higher messaging rates will fall into the higher tiers (\$230,868 to \$404,016 annual cost for top 3 tiers) while those with little or no message traffic would fall into the lower tiers (\$264 to \$1740 for bottom 2 tiers).

The comments presented in this letter are in reference to small options market-maker ("OMM" or "options market-maker") firms¹ and the negative impact the proposed CAT funding fees will have on the ability of this group to continue to operate an options market-making business. Although this category of broker-dealer is relatively small in terms of net worth, due to the characteristics of quoting option classes and the enormous amount of quote traffic generated, many will fall into the top tiers of the pricing model. An annual payment exceeding \$200,000 will prove to be unsustainable for a small OMM business. In some instances, the annual CAT fee would represent an OMM's highest expenditure and exceed 5% of its net revenues. The proposed large cost allocation to a small OMM compared to the small allocation of a large full-service firm with minor electronic messaging and whose net revenues are in the hundreds of millions if not billions of dollars, seems; 1) biased towards small OMM firms, 2) ultimately anti-competitive as small to mid-size OMM's may choose to exit the

¹ Small OMM firms typically employ 10-20 staff, use vendor provided technology and the owners wear many different hats to cover trading, operations and administrative functions within the firm. Annual net revenues are generally under \$5 million.

Comment Letter CAT Funding Proposal

market-making business, and 3) generally unreasonable taking into consideration that the SROs will reap all of the benefits from creating the CAT.

By way of background, the signatories to this letter are private compliance consultants with many years' experience as securities exchange regulators and broker-dealer compliance professionals. As former regulators, we absolutely support the development of an audit trail that brings together equity and options data into a single concise audit trail. Our clients, some who are small OMM firms, also recognize the importance of utilizing modern technology to enhance regulatory processes and support the CAT. However, there are serious concerns as detailed below;

- a) Equitable cost and funding: We support the views first presented in SIFMA's comment letter dated March 27, 2014² addressed to the CAT Advisory Group, that funding should be guided by the following two (2) fundamental principles:

1) Costs should be distributed equitably among CAT users and reporters. Broker-dealers already incur significant overhead costs including registration and permit fees, regulatory costs (DEA fees), trading activity fees and transaction costs; and

2) SROs will realize cost savings due to the efficiencies realized by the elimination of other regulatory processes such as OATS and Blue Sheets.

With no apparent consideration of SIFMA's comments, the Plan Participants have proposed a CAT funding plan where the cost distribution is not equitable. SROs who will be the beneficiaries of savings due to the elimination of several regulatory reporting processes are only allocated 25% of the CAT fees, while broker-dealers have been allocated 75% of the development and on-going costs. The methodology that underlies the fee tiers is also flawed; charging based on "messaging traffic" does not properly account for the number option strikes and series compared to single name equities.

Within the broker dealer community, due to the high level of option quotes, OMMs will be burdened with CAT fees that are disproportionate to their capitalization and standing in the securities industry. The proliferation of options series over the last few years (e.g. weeklies, \$1 and 50 cent strikes) has materially increased quote message levels. The Plan Participants acknowledge that the methodology of charging based on "message traffic" is not perfect because it does not properly account for the number of option strikes and series compared to single name equity shares. Nonetheless the fee tiers are heavily influenced by quote messaging.

² SIFMA comment letter addressed to Mr. Peter Santori of the Chicago Stock Exchange regarding "Priorities for the Development Advisory Group."

Comment Letter CAT Funding Proposal

b) Equitable distribution among CAT reporters

The proposed fee model unfairly targets options market-makers who are required to quote hundreds of thousands of options series. The SEC recognized the existence of this level of quote traffic in their approval order that exempts options market-makers from submitting quote data to the CAT.³ There are currently fourteen (14) options exchanges who continue to list a myriad of option classes (monthly, weekly, ½ point strikes) that will only serve to drive up CAT fees for OMMs. There is even a proposal by one exchange to list daily options. We note that the top 3 Tier fees for industry members are comparable to some of the largest equity execution venues and the costs are considerably higher than the Tier 2 exchanges. This is not equitable nor fair.

Options market-makers are one of the only class of market participants that are required to maintain a presence in the market and provide liquidity by continually quoting a two-sided market.⁴ There are strict exchange rules regarding continuous quoting obligations for OMMs; the rules generally require OMMs to provide continuous quotes in 90% of appointed products for 60% of the day; 90% of the day for options specialists. The consequences of not meeting the quoting requirements is almost always formal disciplinary action.

A small OMM quoting the top 100 active products on a full-time basis can easily fall into a top CAT fee tier. For example, AMZN has call and put option series ranging from the 690 to 1100 strike with series listed in 2 – 5 dollar increments covering 10 expiration months through 2019. AMZN is an active stock and generates hundreds of millions of options quotes daily. Quoting a handful of active option classes will quickly move an options market-maker up the fee ladder with no solution to deter costs.

Under the proposed CAT fee tiers, the small OMM will no longer be able to freely quote competitively as their focus would likely shift from providing a competitive quote to less competitive strategies in an effort to lower their CAT fees. They will also need to be very selective about what options series to quote which may harm liquidity. In some instances, closing their options market-making business and trading in a proprietary or professional customer account where there are no quoting requirements will be the only financially viable business strategy to pursue.

³ The SROs note that the volume of options market maker quotes is larger than any other category of data to be reported to the CAT, generating approximately 18 billion daily records, and believe that requiring duplicative reporting of this already large amount of data would lead to a substantial increase in costs.

⁴ Equity market-makers are required to post a two-sided quote; however, the number of options series greatly exceeds the number of single stocks thus generating a much higher level of quote traffic.

Comment Letter CAT Funding Proposal

c) Distribution of costs among broker-dealers

Under the proposal, OMMs and other electronic trading firms will bear the brunt of the CAT costs when large full-service firms will fall into the lower categories due to a traditional trading model (e.g. high touch) and a low level of electronic messages. These large full-service broker-dealers will benefit from a reduction in other regulatory processes such as the elimination of OATS and Blue Sheets while paying very little for the development or on-going costs of the CAT. Based on information we have collected, the average OMM will reside in Tier 2, 3 or 4. With net revenues of approximately \$3 million or less, the CAT fee represents anywhere from 3% to 8% percent of net revenues. By comparison, we estimate that large full-service broker-dealer(s) with low messaging rates will fall into the bottom tiers and pay a negligible amount. Certainly, this is not equitable nor fair to smaller market participant(s).

d) Effect on competition

In recent years the industry has seen an exodus of small OMMs due to increased costs and lack of profitability. According to a recent article in Barrons, since 2013 CBOE's "dealer community has shrunk to 40 from about 70". Other exchanges have seen similar reductions as well. The CAT fee structure will absolutely exacerbate this trend and may lead to the virtual elimination of such firms. The CBOE states that the CAT funding fee proposal will not cause a reduction in market quality. How can it not reduce quality for customers if it drives out competition and liquidity? The SEC and the exchanges need to consider whether the options market is best served and more competitive with small OMMs no longer participating in the market leaving a handful of large OMMs to support the industry. We do not believe that concentration of this nature is beneficial to the options industry. Some firms have already moved towards the professional customer category because of the fees associated with maintaining a broker-dealer; the approval of the CAT funding proposal will only help increase this trend.

e) CAT and OMM violation categories

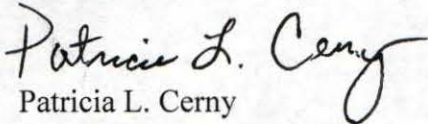
Will the introduction of CAT result in the disclosure of new violative activity for OMMs that is not currently disclosed under current surveillance processes? We think not. The CBOE and other SROs already have sophisticated surveillance reviews in place to monitor OMM trading activity and have taken disciplinary action against OMMs related to quoting violations (e.g. continuous quoting, bid/ask spreads, firm quote, excessive quoting and other technical violations concerning electronic trading). Nonetheless, based on the logic behind the proposed CAT fee tiers, OMMs will incur significant costs to fund the CAT that most likely will not result in any new violation types for this category of broker-dealer.

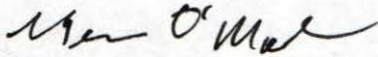
Ironically, OMMs who stand to pay the proportionally highest fees to support the CAT will have no personal benefit as the enhanced audit trail will not include any OMS information that is not already on record through the existing reporting mechanism.

Comment Letter CAT Funding Proposal

In closing we respectfully ask the Commission to consider the impact the funding model will have on fair and orderly markets without small options market-makers providing liquidity for the investing public. This group may be forced to leave the business as fixed overhead costs increase substantially with the proposed CAT fees. Section 6(b)(8) of the Act requires that an SRO rule proposal not impose any burden on competition that is not necessary or appropriate. We do not believe that the proposed CAT fees meet this requirement. The SEC has the burden to ensure that any rule passed does not negatively impact competition, surely the approval of the proposed CAT funding plan will harm competition.

Sincerely,


Patricia L. Cerny



Steven O'Malley

Compliance Consultants