SIG
SUSQUEHANNA INTERNATIONAL GROUP, LLP
401 CITY AVENUE. SUITE 220. BALA CYNWYD, PA 19004-1188. 610.617.2600. WWW.SIG.COM
BALA CYNWYD BOSTON CHICAGO DUBLIN LOS ANGELES NEW YORK PHILADELPHIA SAN FRANCISCO SHANGHAI STAMFORD SYDNEY

October 22, 2010

Via Electronic Submission and Mail

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-0609

Re: SR-ISE-2010-73 (The Modified Qualified Contingent Cross)

Dear Ms. Murphy:

Susquehanna International Group, LLP[1] (SIG) appreciates the opportunity to comment on the modified Qualified Contingent Cross proposal (QCC). We were pleased to see the International Securities Exchange ("ISE") raise the limit on eligible blocks to 1,000 contracts and also modify the proposal to allow customer orders on its book to retain same-price priority over QCC pre-matched crosses. The core problem with the proposal, however, was not addressed by these modifications. That is, as pointed out by the CBOE in its recent comment letter on this matter[2], "the modified QCC would still allow option crosses to occur without prior exposure to the marketplace". Thus, if adopted, the proposal would still permit institutional brokers to avoid competitive interest from option market makers (MMs) on the ISE and instead internalize customer block orders on crosses with favored facilitators (e.g., commission paying firms or affiliated-principal accounts).

In light of the fact that the proposal still contemplates privately arranged and secretly executed block crosses that will undoubtedly result in many inferior execution prices for customers and generally discourage liquidity commitments by MMs, the Securities and Exchange Commission ("the SEC" or "the Commission") should not permit this rule to be implemented

1SIG is comprised of multiple trading and investment affiliated entities. SIG affiliates operate in many trade-related option capacities, including market maker, agency broker and block facilitator.
2 CBOE Comment Letter of August 9, 2010.

Before getting into the details of why QCC would be detrimental to customers and the markets, we should first give deference where deference is due to the ISE. To wit, in its most recent letter to the Commission on this matter[3], the ISE accurately asserted that floor exchanges enjoy an unfair competitive advantage over electronic systems for executing clean (or at least cleaner) blocks. ISE pointed out how large option trades are frequently pre-matched upstairs and then sent to exchange floors for the purpose of executing the "cleanest" possible cross. It explained that the enabling factor behind this activity is that crosses are generally less apt to be broken-up on the trading floors than in the electronic auctions[4]. It contended that it was the floor exchanges that created the "slippery slope" of option block rules by promulgating such cross-friendly block procedures. And, very importantly, it shed light on the fact that the exchanges now opposing QCC are the very same exchanges that refuse to show their own large blocks to anyone other than "those few (if any) members physically present in the floor-based trading crowd for an option". ISE concluded that the reason floor exchanges do not program their hybrid systems to automate block crosses (even while they automate most every other type of transaction) is solely to keep their competitive advantage over electronic systems.

ISE is correct on all these points. Yet, while sorely denouncing the anti-competitive activities of others, it proposes to engage in the very same activities through QCC. Adopting an anti-competitive rule to, ironically enough, level the competitive playing field is not the solution. Two wrongs do not make a right. Instead, since the basic problem is to provide a level playing field for all exchanges, we suggest the SEC achieve that while placing customer interests first. We believe the much better solution is a common rule for all block crosses on all option exchanges, as follows:

> **Require all pre-negotiated option block crosses, including floor crosses, to be entered into an electronic crossing mechanism where MMs registered in that option on the respective marketplace can compete on equal terms with other facilitators to ensure best execution for customers.**

If full MM competitive pricing is ensured for all pre-negotiated option blocks, brokers will better meet their due diligence requirements in securing best execution for block orders. It would also incentivize MMs to commit more capital and resources for block order facilitation. The end result would be a more efficient option market for customers. The value-added from this approach, in the form of much more price improvement and deeper liquidity, would be of tremendous value to block customers.

---

3 ISE Comment Letter of August 25, 2010

4 Interpreting the results on the Break-Up rate study by the SEC's RiskFin Division (floor exchanges v. the ISE's crossing mechanisms) appears dependent on how much weight should be assigned to certain variables inapplicable to QCC. Our own experience in the markets is that institutional brokers are much more apt to use a trading floor when the primary intention is to execute as clean a cross as possible.

On the other hand, if QCC is approved it will make the ISE a favorite destination for brokers intent on executing stock-option orders at dubious prices. It will immediately deprive option customers of best execution and, in the long-term, encourage more rules designed to capture volume at the expense of best execution. After all, once it has been approved for the ISE, other exchanges will be compelled to make copycat filings for competitive purposes. The aforementioned slippery slope of faulty rule making will accelerate and severely lessen transparency for block trades. Institutional customers not fully sophisticated in option pricing practices will be particularly vulnerable to poor execution from lax crossing rules. In a market replete with clean cross blocking rules, MMs will only be solicited on blocks deemed too risky by brokers to facilitate as principal or too risky for their commission-paying facilitator firms. This side-lining of MMs will erode competition in the market and eventually force MMs to refocus capital and resources to trading products where they have a better chance of competing.

Although the proposal refers only to blocks, withholding competition from option MMs for block orders will result in less liquidity for option orders of all sizes. This downstream effect would be different than what we saw with the stock market's migration away from the more traditional auction style trading of blocks. In stocks, block-sized liquidity sources are much more diverse – and pricing is not dependant on the ability and willingness of a small group of MMs to set quoted prices. But in options, where MMs provide over 90% of the liquidity and basically set the displayed prices, the impact would be pronounced. Pushing MMs out of the block facilitation business will leave them with fewer trading and hedging opportunities and thereby make them less able, and less inclined, to quote as aggressively as they do now in option products in general. The SEC should remain mindful of the differences between the two markets in this regard, so that option rules are not approved on the basis of "what was acceptable for the stock market must be acceptable for options".

The Commission has, in fact, reflected a healthy appreciation for these differences over the years. When exchanges caucused in the 1990's to secure guaranteed participation on pre-matched crosses for favored facilitators, the SEC wisely set a 40% ceiling on that participation. This ensured that MMs would still be motivated to compete and provide for best execution. In the years that followed, the 40% ceiling rate was often debated, but never changed. The debate, it seems, always returned to the fact that MMs compete against each other to set prices for all orders, large and small, and relegating them away from the block process would have broad and long-term detrimental effects on the options market.

The need for MMs to provide price-integrity quotes on blocks continues today. The ISE's Solicitation Mechanism provides a good example for assessing the value MMs bring to the block crossing process. Although the block volume on this one system constitutes only a small percentage of overall block volume in options, we estimate from available data that its price improvement percentage in recent months has nonetheless been over ten percent[5]. This leaves no doubt that MM price improvement on electronically auctioned block crosses already saves buy-side institutions millions of dollars each year in price improvement. With broader dissemination to MMs (as we recommend above), the savings could be exponentially higher.

Moreover, while actual MM price improvement is a significant contributor to best execution, an even greater contributor would be the effect such a requirement would have on the prices brokers originally choose for block crossing. Knowing that their crosses will be scrutinized by the full regiment of competitive MMs will force brokers to refrain from choosing overly favorable prices for the facilitating side to a pre-matched cross.

While we speak to the fact that QCC would deny MMs from competing on price for the benefit of the customer, the ISE dismisses this concern with the explanation that there is no need to shop MMs on the option leg because QCC only pertains to stock-option orders. The ISE claims that such blocks are not prone to the same price improvement arguments applicable to single-legged option blocks. In its most recent letter, ISE asserted that "*...price improvement of the individual legs of the trades is not a critical issue in executing the QCC.*"

Rather than serving to ameliorate any concerns about best execution, this claim serves to make matters worse. Specifically, in order to avail upon the benefits bestowed upon the broker by QCC, brokers wishing to effect clean crosses would be encouraged to split stock-option orders into two executions rather than seek price improvement from MMs as a single combination order (i.e., as a "combo' order quoted on a net debit or credit). Though it is true that the price of one leg executed individually would not be critical to the overall investment price *if both legs are privately pre-matched away from the exchange at a net debit or credit*, it is also true that brokers often get better "net" prices when they auction both legs as a combo order to competitive MMs.

From a best execution point of view, pre-arranging a customer's stock-option order at a net price with a favored facilitator and then splitting the order for execution as two separate trades may be appropriate in certain situations but is usually not in the best interest of the customer. The fact is that MMs quote more aggressively for combo orders (quoted at a net debit or credit) because of the built-in stock hedge to the order, which reduces net risk. Less risk means tighter quotes. Given this, it is hard to

---

5 Based on estimates from available ISE data, ISE Solicitation cross orders for a recent five-month period were price improved (upon display in that system) over 10% of the time. The number of price improved contracts was in excess of 400,000 contracts during that period.

imagine how QCC will help customers or serve to promote broker due diligence in any way.

Still another troubling aspect in this regard is that approving QCC would create a new perception among market participants that would compromise current understandings about best execution. That is, such approval would suggest that splitting the legs to stock-option orders in this fashion (i.e., without obtaining competitive MM quotes on a net basis) must be consistent with best execution and due diligence because the SEC approved it as an order handling scenario, complete with a priority exemption and no prior disclosure requirement. This would not be helpful to customers.

We appreciate the ISE's frustration with unfair crossing rules for blocks. We assume it must be compounded by the fact that it already has an electronic stock-option combo execution feature built into its crossing systems, which does provide *price improvement opportunities on a net basis* but does not generate a great deal of block cross executions. Of course, while this feature offers an efficient means for brokers to attract contra-side interest for stock-option order flow, it is not the best choice for a broker intent on executing a clean cross combo. Again, exposing such orders to "net" pricing competition by MMs often translates into higher break-up rates (and, by the way, more price improvement). Exchanges should not have to suffer a competitive disadvantage for blocks because their systems offer more price competition.

If QCC is implemented, we expect that many more stock-option blocks would be handled in this split-execution fashion, particularly after other exchanges seek similar rules for competitive reasons. It is estimated that over 25% of all option volume is constituted by large blocks. We estimate that most large blocks involving customers also involve near concurrent stock hedging. This means that the QCC proposal, if approved, would place a large percentage of the block business outside the realm of competitive MM quoting, which will negatively impact the way MMs quote and interact in the market. Indeed, while QCC may not on the surface appear to be a catalyst for far-reaching effects to liquidity in the options market, its ripple effects will quickly surface and be felt fully by brokers, dealers and institutional customers.

This leads us to another point of contention with the ISE's characterization of the issue in its filing and responses. That is, the ISE has characterized the QCC proposal as simply a dispute between exchanges. It claims that the dispute does not directly involve broker-dealers and asserts that *"...broker/dealers generally have no incentive to involve themselves in such disputes."* This is not the case. Option brokers and dealers are naturally interested in rule developments that raise best execution concerns. In a case such as this, involving a rule filing pitched as a dispute between exchanges, broker/dealers are especially dependent on the SEC to resolve the issue in the manner that best protects market integrity for their customers.

The paramount concern is how this rule filing would impact best execution for customer orders. One would expect that buy-side institutional customers would naturally be against a rule filing that encourages brokers to split-up their stock-option orders so that competitive MMs never have the chance to price improve on a net basis. In our own survey of numerous large sized institutional buy-side option users, each responded that they are against this proposal and other similarly situated rules that would deprive them of competitive pricing for their block orders[6]. We could not find one buy-side institution that thinks this proposal is a good idea.

This brings us to the matter of market access and quick response times. The age-old practice employed by most institutional brokers for obtaining best execution was to secure bids/offers from competitive MMs before executing a matched cross on an exchange. In the days before electronic matching systems, matched crosses would be shopped on floors where brokers would be met by MM crowds that were considerably larger than they are today. Of course, some floor crowds were less competitive than others on block trades, which sometimes led to brokers being questioned on why a block was represented in a less-liquid crowd. The age-old excuse from some brokers was largely about timing and access. Specifically, the amount of time it would take to access and shop an order to another exchange in a fast moving market and whether the broker had a floor unit on that exchange to handle the order.

In this age of sub-second electronic access and split second auction display times, the timing and access excuse is no longer valid. If best execution is better assured by making sure that the full regiment of an exchange's MM base has the opportunity to compete on price for the customer's order, then brokers should be required to display or auction the orders appropriately, which means electronically. The level of transparency in the option block order process should be growing not receding, which makes it an excellent area for the SEC to generally target for possible rule changes[7].

In this connection, there appears to be a general inclination among exchanges to adopt rules that raise concerns similar in most respects to the QCC issue. For example, the ISE and NASDAQ-OMX now have rules that allow brokers to display one contract from a block order (while hiding the block order behind the one contract display) and after one second facilitate the balance of the order without any further public display. This so-called hidden-cross rule needlessly costs customers price improvement, especially for smaller sized blocks. In an effort to justify the existence of these rules, some presume that MMs could simply "ping" every one-lot displayed at a price they

---

[6] SIG's institutional broker affiliate, SFG, is an active participant in the option block business that services many large institutional buy-side accounts. In our survey, some of SFG's larger option block customers were asked to opine. We believe the respondents were representative of the institutional option block business in general.
[7] We incorporated this statement about transparency, and several of those beneath it, into our comment letter on flashing in the options market.

would consider trading a block. Thereafter, it is presumed, the MM could send additional interest to trade with the full amount of the hidden order. There are many logistical issues in options trading that make this presumption unworkable. In any event, the more obvious problem with the hidden-cross rule is that it automatically deprives the customer of any chance of getting price improved. This is an example of rule making that by its very design serves to stymie competition in the options market[8].

In a similar vein, NYSE-ARCA recently proposed a rule change to require floor based MMs to disclose their final markets in a series when a floor broker queries the trading crowd prior to the disclosure of an intention to effect a block cross transaction. This practice would allow brokers to by-pass normal due diligence in the handling of option blocks.[9] This filing has since been modified but remains an example of the recent clean-cross theme among rule filings that value clean cross revenues over price improvement opportunities for option block customers.

Similarly, the NYSE-Amex recently raised Trading Permit fees for MMs by a factor of five while leaving the permit fee for brokers unchanged.[10] The Market Maker Trading Permit fee now stands at ten times that of a Floor Broker. Although such fee increases when considered outside of this environment might be considered mostly benign, this action could reasonably be viewed as an attempt to drive away floor based MMs (i.e. and thereby keep them from breaking-up clean crosses).

In conclusion, while we agree with the ISE's contention that there is an uneven playing field for crossing option blocks, we believe the QCC proposal would hurt block customers and the market in general. The SEC should not allow it to be implemented and should take the steps necessary to weed-out all other block crossing rules that likewise harm best execution in the options market.

Sincerely,

Gerald D. O'Connell
SIG – Chief Compliance Officer

---

[8] NASDAQ OMX Chapter VI Rule Section 1(e)(4), ISE Rule 715 (g)
[9] SR NYSE ARCA 2009-69 (2010-90)
[10] SR NYSE Amex 2010-10

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
James A. Brigagliano, Division of Trading and Markets
Robert W. Cook, Division of Trading and Markets
David Shillman, Division of Trading and Markets
Heather Seidel, Division of Trading and Markets
Daniel Gray, Division of Trading and Markets
Steve Williams, Division of Trading and Markets
Theodore Venuti, Division of Trading and Markets
Arisa Pinaves, Division of Trading and Markets
Henry Hu – Risk, Strategy and Financial Innovation
John Roeser, Division of Trading and Markets
David Liu, Division of Trading and Markets