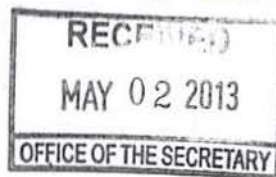


4-662



April 22, 2013

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Petition for Rulemaking under Rule 192 - Option Floor Crosses

Dear Ms. Murphy:

The undersigned listed options market maker firms ("MM Firms") hereby submit this petition for rulemaking (the "Petition") to the U.S. Securities and Exchange Commission ("the Commission") requesting that the Commission require that each U.S. registered options exchange with a physical trading floor:¹

- Provide an "electronic-cross auction mechanism" ("ECAM") for all multiply listed option products traded on its physical trading floor and ensure that it is made electronically accessible from off the trading floor, as well as on the floor, by qualified exchange members;
- Require that all block-sized "matched option crosses" in multiply traded products listed on its exchange, involving one or more customer orders, be auctioned through such ECAM²; and

¹ Currently, there are four exchanges with physical trading floors: the Chicago Board Options Exchange (CBOE), Nasdaq-OMX (Phlx), NYSE MKT (AMEX), and NYSE ARCA (PCoast).

² In certain instances, a trading crowd on an exchange could reasonably evidence itself as a "major market floor participant" in a product when it routinely sets the prices and constitutes a significant percentage of the trade and contract volume for the product. This would presumably be the case for singly listed issues and could perhaps apply in other instances as well; for example, certain actively traded index/ETF products. In the case where a crowd can evidence itself in this way, the respective exchange should be considered for an exemption from the proposed ECAM requirement for that product.

- Require that the customer side(s) to the matched cross (buy and/or sell) be identified as "for the account of a customer" through the ECAM during the auction process so that authorized qualified members, including off-floor market makers registered on the exchange in the respective security (off-floor MMs), are able to respond directly with liquidity for the side marked as "customer".

For purposes herein, the following definitions apply:

- (1) The "electronic-cross auction mechanism" (ECAM), used in connection with a floor-based execution in a multiply traded option, refers to an electronic order matching system that can receive an option cross matched outside the trading crowd and then display it simultaneously to all qualified members (on-floor and off-floor) before executing the matched cross as a final trade. In such an ECAM transaction, participation on the contra-side to the customer's order is allocated in accordance with the respective exchange's prevailing parity and priority rules. ECAMs should be constructed so that the customer side(s) to the order is able to receive the liquidity and pricing benefits from all interested qualified members before the order is finally matched for execution.
- (2) A "matched option cross" is defined as two or more matched off-setting option orders where buy and sell orders are executable against each other and where at least one side of the order includes block-sized customer interest. In addition:
 - (a) Related orders to the matched option cross should be considered applicable to the ECAM display requirements. For example, contingency legs of such orders (e.g., spread orders and contingent hedges such as stocks, ETFs and futures).
 - (b) The definition of "block sized" should be 500 contracts or greater. Options related orders of smaller sizes should be eligible for processing in the ECAM at the broker's discretion or at the customer's request. (It is noted that several exchanges already provide crossing mechanisms

for such matched orders that operate largely in the fashion recommended herein³. Most larger-sized blocks are not, however, executed through such systems).

- (3) The definition for “qualified members” should (at a minimum) include all registered options market makers in the respective option on the respective exchange – including floor based MMs and off-floor MMs.
- (4) The “customer interest” definition should include option orders placed for the benefit of a person other than a broker/dealer (“customer”), including orders for such customers represented on a discretionary basis by a broker/dealer or executed on a riskless-principle basis for a customer.

Background

The U. S. listed options market is one of the most liquid securities markets in the world. Much of the credit for this deservedly goes to the comprehensive national market system (NMS) for options that links the exchanges under a common accord to have national best bid/offer displayed prices (“NBBO”) be directly accessible to investors – and supports it with an inter-market trade-through rule. In addition, throughout these past forty years of growth and development, the options industry has greatly benefited from the diligent efforts of the brokerage community (at large) to ensure that the investment needs of option customers are given paramount importance. Complementing these many efforts has been the contribution by options Market Makers who routinely provide highly competitive quotes in thousands of options classes. The fact that over 90% of displayed option liquidity emanates from these MMs stands in testimony to their quoting commitment and competitiveness. The beneficial consistency of this MM liquidity can be appreciated from the fact that the options market operates as a highly liquid “quote driven” market (as opposed to an “order driven” market like stocks). Indeed, there are currently over 500,000 option series quoted by these MMs each trading day.

The measure of any public market rests in its ability to provide liquidity to customer orders. In this regard, the options market benefits from a unique mixed MM model that creates competitive

³ For example, the Facilitation Mechanisms for block crosses - on the CBOE, ISE, Phlx and BOX.

quotes for orders of varying sizes. This structure is comprised of two intertwined models that operate symbiotically to address the panoply of diverse investor liquidity demands. In this connection, MMs display quotes with prices and sizes that often vary depending on whether the respective MM is operating from an exchange with a price-time/maker-taker model ("price-time") or a pro-rata/traditional option model ("pro-rata")⁴. While the price-time options exchanges encourage tight quotes for small-lot orders, the pro rata options exchanges afford more quoted liquidity for larger sized orders. The net result of these competing MM forces is a more tightly quoted and more liquid market for everyone.

Given the growing use of options as an investment tool and the competitive structure of the options market in general, it is no surprise that the options market currently enjoys the benefit of a highly competitive market maker population. Indeed, the level of displayed liquidity in options frequently surpasses the NBBO displayed liquidity in the underlying stocks. The explanation for this relates in great part to the fact that pro rata MMs are quoting options that overlay stocks that, for the most part, are being quoted under a price-time model. Because the pro rata model awards a greater participation rate to those quoting at parity in larger sizes, pro rata MMs are incentivized to display quotes in larger sizes. In fact, most pro rata MMs habitually display in sizes larger than the sizes at which they would optimally like to trade on an auto-execution basis. While these over-sized displays of liquidity makes MMs susceptible to higher levels of auto-executions during volatile periods, displaying more size is a risk-reward calculation accepted by such MMs in exchange for the opportunity to participate at a higher rate for the full breadth of incoming orders into that market. The natural benefit of this larger-size pro rata quoting model is more size for those customers in need of deeper liquidity.

Thus, given the heightened level of competitively displayed quote depth provided by MMs, and in particular pro rata MMs, it stands to reason that block orders should be greatly benefiting – much like smaller sized orders do – from the willingness of these competing MMs to generally provide deep liquidity for customer orders. Yet, unfortunately, this is not the case to the degree it could be. As discussed below, the degree by which brokers with block sized orders access the

⁴The "price-time/maker-taker" market provides a price-time priority among resting orders and normally an access fee to take liquidity. The "traditional"/"pro rata" market allocates contracts from incoming orders in price parity situations on the basis of displayed size (i.e., the relatively larger size the quote maker is displaying, the more contracts likely to go to that quote maker against incoming orders).

deepest sources of MM liquidity is often a function of the order size – with the amount of liquidity that is accessed often decreasing as the size of the block order increases.

More specifically, most small sized block orders (those of a few hundred contracts or so) can simply and directly execute against displayed MM quotes as auto-executions. For these sized orders, investors benefit tremendously from the fact that near-term/at-the-money option series in the top 400 or so option classes generally reflect displayed sizes of several hundred contracts or more at the NBBO. However, because many of the larger sized option blocks are greater in size than NBBO displayed sizes, brokers must often choose whether to “work” the order in the market or attempt to arrange a matched cross for “auction”.

Working a customer’s order usually involves breaking the order into smaller pieces by electronically hitting the best bid or taking the best offer (as the case may be) at varying price levels until the customer’s order is completed. Sometimes there is the concern that the market will move away in price before the order can be completely worked for its full execution. In these cases, it might appear less risky to instead arrange for a selected contra-side liquidity provider to fill the order at a block price. If so, the broker will typically solicit (i.e., “shop”) one or more liquidity providers to agree on a prompt fill of the order at one set price. When this occurs, the off-setting orders are then brought to the marketplace to be auctioned as a matched cross.

No doubt, it can often be a difficult decision on whether to work an order or shop it. Sometimes the decision is not a simple choice between the two. For example, in some cases it may appear prudent to first work an order for a partial execution at displayed prices and then shop the balance as a block trade at a “clean up” price. In still other cases, brokers receive matched orders from other brokers with specific instructions that they should auction the order as a cross. Ultimately, in prudent fashion, the broker must gauge the execution risks between auctioning an order for a one-price fill and working it in the market. With each decision comes the overlying question of whether the shopping process can elicit a better “block price” for the customer’s interest than an average price from working the order in the piecemeal fashion described above.

Consequently, when a broker decides to execute an order as a block cross, the merit of that decision relies primarily on the quality of the competition provided by the liquidity providers involved in both the shopping and crossing phases. No doubt, each function has its own important role in the final pricing.

While the shopping process can elicit a competitive price, it is a process that is also prone to elicit a price predicated on the level of competition perceived by the shopped parties to be resident on the exchange where the auction cross is to take place. Therefore, it is important for the respective exchanges to enable and encourage their deepest liquidity providers to actively participate in the auction process. Otherwise blocks can cross at prices that have not been sufficiently vetted by those most suited to perform that task.

When brought to auction, the level of liquidity available on the respective market needs to be deep enough to supplement for the possibility that the matched crossing price is lacking. This may occur because the shopping process is limited in its scope to varying degrees. For example, shopping a block order in a volatile market may not allow enough time for the broker to shop it exhaustively. Also, in cases where a firm decides to shop an order for a block fill, the broker may determine to solicit its own proprietary options desk. If the affiliated options desk is interested in participating at a certain block price that is acceptable to the initiator, the shopping process might not be extended to additional third parties and there could be lost opportunities from other liquidity providers. The liquidity shopping process can also be shortened, and opportunities lost, in the event a non-affiliated party is shopped on an agency commission basis and commitments arise in relation.

Consequently, the auction process is an important backstop to the shopping process. It can serve an important service in providing additional competition and liquidity to better ensure the integrity of the matched price. When the decision is made to shop an order and then bring it to auction, the auction should perform as a reliable safeguard to ensure the competitive credibility of the block price. For example, if the shopped price is not a very competitive price, the auction process should make sure there is the opportunity for a more competitive liquidity provider to step in and offer a better price. In this connection, in order to make the auction process as credible as possible, it should include the deepest and most prevalent liquidity providers – which means that it should always include the most liquid MMs registered in that product at that exchange.

Given the combined concerns over proper vetting in certain auction processes and order-handling proclivities that can sometimes narrow the shopping process, it can be seen how liquidity can be missed in the process of executing matched block crosses. As to whether this is a growing problem, the answer is undoubtedly yes. The fact is that the options industry is increasingly

attracting institutional order flow, and larger sized block orders are on the rise. Moreover, larger-sized blocks constitute a growing percentage of overall daily option volume⁵. In fact, block orders of 500 contracts or greater currently constitute over 30% of listed options volume. Thus, it is no wonder that exchanges compete vigorously to attract large block order flow. However, while vigorous competition among exchanges typically bodes well for customers, the process for executing these kinds of larger-sized orders is often less than what it could be for the customer. The problem, in brief, is that exchanges currently offer two auction methodologies for crossing such blocks – and the dominant methodology is inherently flawed.

Specifically, in options, there is (i) the open-outcry floor cross and (ii) the ECAM-styled electronic auction. The majority of large block volume is executed through the manually handled floor cross method, which is a method offered on four options trading floors. Floor crosses are specialized trades where prices are negotiated directly on the floor between buyers and sellers, in person, rather than entered into an electronic system for auto-execution against a price and size publicly displayed and then crossed on the floor. In the open-outcry method of executing blocks, brokers enter a trading floor crowd and voice the interest to whomever is present on the floor in that crowd at the time. The flaw inherent with the floor cross system is that in most cases very little of the available liquidity for multiply traded options is present in the crowd at the time a floor cross is announced and transacted. This is a shortcoming that could have been rectified by electronically linking the registered off-floor MMs to the auction process, but the floor exchanges have not enabled their systems with ECAM styled features to solicit their off-floor MMs to compete in such crosses. This is the case even though the vast majority of MM liquidity is no longer represented in person on the floor, and even though off-floor MMs could be easily included through ECAM-styled systems if the floor exchanges decided to add that functionality to their trading systems.

Thus, many of these larger-sized blocks are “auctioned” out of sight and reach of the market professionals that provide the vast majority of the available liquidity in the subject option class. This is unfortunate because these same MMs that routinely display such deep quotes in so many series from off-floor would compete aggressively if electronically included in the on-floor process.

⁵ In February 2013, overall option ADV was 17 million contracts with larger-sized option blocks (500 contracts or more) averaged almost 3,000 transactions per day. This amounted to over 5 million contracts per day of large block activity.

Twenty years ago the trading crowds in multiply traded issues were large. Ten years ago, they became much smaller. Today, for the most part, they are either just one or a few persons. Indeed, it appears the migration of MMs off-floor continues even to this day. A conservative estimate is that less than 20% of overall MM liquidity is now available for quoting in-person in the vast majority of floor trading crowds of multiply traded options where large block cross orders are auctioned. This percentage is even lower for the less active options, and often much lower on certain exchanges where the volume and trading crowds are the smallest for the respective securities. The level of quote competition in multiply listed options available to open-outcry floor crosses continues to dwindle, and unless floor exchanges are required to change practices it would appear that this flaw will continue to plague the options business for many years to come. Meanwhile, technological advances continue to ease the task of managing MM quotes from off-floor.

Thus, while the need for a more robust and integrated auction process on trading floors appears to be advantageous from a market structure point of view, it fortunately appears that the changes would be easily implemented from a technological point of view.

The absence of initiative by the floor exchanges to institute these ECAM styled changes prompts the need for the Commission to lend its support to the requested changes. In this connection, this Petition is focused on encouraging the support necessary to create a crossing structure that will ensure an auction process for floor exchanges that makes such MM liquidity available to the customer side(s) of block crosses. It contemplates that involving off-floor MMs in the process will not only create price improvement opportunities, it will also encourage off-floor MMs to engage more actively in ECAM styled systems across the market. Exchanges can expect the off-floor MMs to add significant liquidity for such crosses by maintaining the current parity and priority participation rules of the current systems, which are an excellent incentive to quote aggressively as evidenced by existing ECAM systems.

Off-floor MMs would enthusiastically contribute to liquidity if the steps were taken to include them in the auction process for floor trades. And the resulting increase in liquidity, along with instances of price improvement, would be significant. In the meantime, allowing blocks to be narrowly shopped and crossed in mostly vacated trading crowds on the floors is a needless loss of opportunity for customers in need of liquidity.

An ECAM system would especially improve the market for combination and spread crosses, which are not currently given any inter-market NMS trade-through protection. It is estimated that over 500,000 contracts per day execute as spreads on the option trading floors, which amounts to over 100 million contracts annually. In many of these cases there was a significant population of off-floor MMs in the product that could have added liquidity to the order but were never given a reasonable opportunity to do so. Spreads and combination orders are especially applicable in this regard. That is, hedged trades can often elicit tighter prices than displayed quotes from liquidity providers (on an aggregate net debit/credit basis) because the combination or spread prices include the risk-reduction effect of the built-in hedge. If a decision is made to require ECAM-styled systems for floor exchanges, it should most certainly include spread and combination orders.

While some supporters of the status quo have suggested that if off-floor MMs wish to participate in large sized blocks, all they need do is show greater size in their publicly displayed quotes and thereby participate with these larger sized block orders on an auto-execution basis. This suggestion fails to appreciate the risk-difference between an auto-execution trade and an auctioned trade. More specifically, the size of the customer order is divulged in the auction process before the liquidity provider gives the final quote. In contrast, the displayed MM quotes are typically made public for auto-execution without any foreknowledge by the MMs as to the size of any incoming orders. This distinction is important because more liquidity can often be solicited from MMs when they are provided details about an order such as the size of the order or perhaps whether a hedging trade is available. These important details about an order are normally provided to off-floor liquidity providers when they are directly shopped by a broker seeking block sized liquidity. This helps the liquidity provider to measure the attendant risk of filling the order, which in turn encourages the liquidity provider to give more liquidity than what he or she would be willing to display publicly on an exchange order book.

It is undoubtedly true that showing the customer's size during the auction process often elicits a better price from the liquidity provider because knowing the size of the order is an important factor in pricing. Therefore, it is likewise true that MMs without such knowledge are at a disadvantage to those with pre-knowledge of the order's size and related hedges. As off-floor MMs must often compete via displayed quotes with facilitators that have prior knowledge as to the size of the block order, the MMs are not in a good competitive position to give all the liquidity they

would otherwise provide to block orders. Bringing the off-floor MMs into the auction process for such blocks would address that inconsistency. Meanwhile, in contrast, it should be noted that order "size" is disclosed to all parties in the typical ECAM-styled auction process.

The open-outcry method of trading pre-dates the origin of the options market itself. When listed options trading began four decades ago, pricing was set through an open auction process where throngs of MMs stood ready, willing and able to respond vocally to incoming orders. This was the traditional auction style of the commodity pits on the CBOT and CME, which in turn were replications of the auction process used to bring buyers and sellers together in a host of varying American commercial venues. It is a model that has served customers well for a very long time. In modern times, however, electronically replicating the innate nature of a robust floor trading crowd engaged in a dynamic auction process is not only easily accomplished, it has already been done. Indeed, the several options exchanges that already offer ECAM-styled electronic auctions for block trades have shown that the auction feature of floor trades translates well into electronic formats. These current ECAM option crossing systems for blocks suggest themselves to be superior to floor crosses at attracting competition on price and volume when given the chance⁶. It only remains for us to bring all floor crosses of block orders in multiply traded options under the light of ECAM styled systems.

The premise of this Petition is that option customers could receive considerably more liquidity and very often better prices if their large block orders were exposed to additional off-floor MM liquidity through ECAM-styled systems. This Petition does not seek to eliminate block auctions, but rather, enhance them by electronically linking off-floor MMs to the floor-auction process for block crosses. This would be an excellent way to elicit liquidity for larger sized option blocks – and there is no good reason why customers should not be provided the benefits of that liquidity.

The MM Firms reflected below, which together constitute a significant portion of the MM liquidity displayed in multiply traded listed options, request that the Commission require that ECAM-styled systems described herein be incorporated into the floor-based block cross auction procedures. The recommendation is to apply this requirement to the four "floor exchanges" for options, as well as any exchange proposed floor-based option crossing procedure in the future. In

⁶ The Facilitation Mechanisms for block orders in place at the ISE, CBOE, BOX and PHLX attract MM liquidity that appears to translate into pricing that is favorably related to mid-point values.

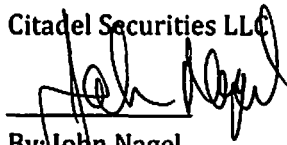
Ms. Elizabeth M. Murphy
April 22, 2013

so doing, the Commission will be allowing block-sized customers to receive the benefits of added liquidity and price improvement opportunities while also encouraging more competition among registered options MMs.

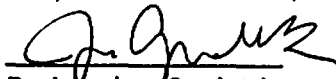
Please feel free to contact any of us with any questions concerning this Petition.

Sincerely,

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