

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR PART 242**

**[Release No. 34-62445; File No. S7-21-09]**

**RIN 3235-AK40**

**Elimination of Flash Order Exception from Rule 602 of Regulation NMS**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule; reopening of comment period.

**SUMMARY:** The Securities and Exchange Commission (“Commission”) is reopening the period for public comment on a proposal to eliminate the flash order exception with respect to listed options from Rule 602 of Regulation NMS under the Securities Exchange Act of 1934 (“Exchange Act”). The proposal originally was published in Securities Exchange Act Release No. 60684 (September 18, 2009), 74 FR 48632 (September 23, 2009).

**DATES:** Comments should be received on or before August 9, 2010.

**ADDRESSES:** Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File No. S7-21-09 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File No. S7-21-09. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, N.E., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Theodore S. Venuti, Special Counsel, at (202) 551-5658, Arisa Tinaves, Special Counsel, at (202) 551-5676, Gary M. Rubin, Attorney, at (202) 551-5669, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

**SUPPLEMENTARY INFORMATION:**

**I. Introduction**

Rule 602 of Regulation NMS<sup>1</sup> and Rule 301(b) of Regulation ATS<sup>2</sup> require exchanges and alternative trading systems ("ATs"), respectively, to provide their best-priced quotations to the consolidated quotation data that is widely disseminated to the public.<sup>3</sup> In September 2009,

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<sup>1</sup> 17 CFR 242.602.

<sup>2</sup> 17 CFR 242.301(b).

<sup>3</sup> Consolidated quotation data captures the best-priced quotations from exchanges, ATs, and other trading centers for listed cash equities and options. This core data for a security

the Commission proposed to amend Rule 602(a)(1)(i)(A) to eliminate an exception for the use of flash orders with respect to trading in both NMS stocks and listed options (“Proposal”).<sup>4</sup> The exception applies to quotations that are executed immediately after communication, or cancelled or withdrawn if not executed immediately after communication. Flash orders are exposed to some market participants for a brief period of time (generally less than one second), but are not included in the consolidated quotation data pursuant to the Rule 602 exception. Moreover, flash orders generally are immediately executable at prices that equal (or “lock”) the best displayed quotations on the contra side of the market, yet the orders are flashed rather than being immediately routed away to another market to execute against the quotations that establish the best prices.

With respect to listed options, the Commission is reopening the comment period to invite additional comment on the issues set forth in this release, as well as any other issues that the public wishes to address with respect to the Proposal as it would affect the listed options markets.

Of the 93 commenters that submitted views on the Proposal to the Commission, 67 generally supported the Proposal, 12 generally opposed the Proposal, and another 9 opposed the Proposal specifically for trading in listed options.<sup>5</sup> Supporters generally believed that

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is consolidated and distributed to the public by a single central processor pursuant to Commission rules.

<sup>4</sup> Securities Exchange Act Release No. 60684 (September 18, 2009), 74 FR 48632 (September 23, 2009) (“Proposing Release”). The Proposing Release contains a detailed description of a flash order. See Proposing Release at 48633 – 48634.

<sup>5</sup> In addition to the supporting and opposing commenters, five commenters neither supported nor opposed the Proposal. Copies of comments received on the Proposal are available on the Commission’s Internet Web site, located at <http://www.sec.gov/comments/s7-21-09/s72109.shtml>, and in the Commission’s Public Reference Room at its Washington, DC headquarters.

eliminating the flash order exception would address the potential for two-tiered access to information concerning the best available prices for a security, encourage the public display of liquidity, and enhance the fairness of the markets for investors.<sup>6</sup> Those opposing the Proposal generally believed that flash orders can benefit investors by attracting additional liquidity and by helping to minimize trading fees.<sup>7</sup>

Specifically with respect to listed options, those opposing the Proposal focused on the differences between the cash equity and the listed options markets. For example, four commenters addressing the Proposal for listed options emphasized that there is no regulatory cap on the fees charged by listed options exchanges to access their best displayed quotations,<sup>8</sup> in contrast to access fees in the cash equity markets which generally are capped at \$0.003 cents per share by Rule 610(c) of Regulation NMS. Moreover, a commenter emphasized that access fees are significantly higher in the options markets than in the cash equity markets, on both an absolute basis (\$0.003 per share for cash equities and \$0.0045 (per share equivalent) for options on one exchange) and a percentage basis (0.0176% of the average stock price for retail investors and 0.266% of the average option price for retail investors).<sup>9</sup> Commenters also were concerned

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<sup>6</sup> Supporting commenters included individuals, industry groups, exchanges, and broker-dealers.

<sup>7</sup> Opposing commenters included 6 individuals, exchanges, an electronic communication network (“ECN”), a broker-dealer, and two academics.

<sup>8</sup> Letter from John C. Nagel, Managing Director and Deputy General Counsel, Citadel Investment Group, Inc. (“Citadel”) dated November 20, 2009 (“Citadel Letter”) at 2; Letter from Peter Bottini, EVP Trading and Customer Service, and Hillary Victor, Associate General Counsel, optionsXpress, Inc. (“optionsXpress”) dated November 25, 2009 (“optionsXpress Letter”) at 3; Letter from Thomas F. Price, Managing Director, Securities Industry and Financial Markets Association (“SIFMA”) dated December 1, 2009 (“SIFMA Letter”) at 5; Letter from Christopher Nagy, Managing Director Order Strategy, TD Ameritrade, Inc. (“TD Ameritrade”), dated November 23, 2009 (“TD Ameritrade Letter”) at 2.

<sup>9</sup> Citadel Letter at 5.

that, in the absence of a fee cap for options, elimination of the flash order exception could lead to even higher access fees.<sup>10</sup>

To assess further these commenter concerns and other issues, the Commission is reopening the comment period for the proposed elimination of the flash order exception with respect to listed options. Additional comment is requested below on, among other things the effect of a proposed cap on access fees for listed options,<sup>11</sup> and on the execution quality that flash orders receive in the options markets. The Commission is particularly interested in the extent to which flash orders, if they fail to receive an execution in the flash process, “miss the market” by either receiving an inferior price through an execution against a displayed quotation or no execution at all. No useful data was provided on this crucial execution quality issue during the initial comment period. Two exchanges that use flash order mechanisms indicated that their fill rates for flash orders were in the range of 60-70%.<sup>12</sup> They did not, however, provide data on the execution quality, including implementation shortfall, of orders that failed to receive an execution in the flash process.

## **II. Requests for Comment**

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<sup>10</sup> Citadel Letter at 6; TD Ameritrade Letter at 4.

<sup>11</sup> See Securities Exchange Act Release No. 61902 (April 14, 2010), 75 FR 20738 (April 20, 2010) (“Access Fee Release”) (proposing a new rule relating to access to quotations for listed options that would cap access fees). Commenters on this release and on the Access Fee Release should be aware that the flash order and access fee issues, though related, are not necessarily linked. In formulating their views, commenters should recognize that the Commission will assess each proposal individually and could decide to take further action on one or both.

<sup>12</sup> Letter from Tony McCormick, Chief Executive Officer, Boston Options Exchange Group, LLC (“BOX”), dated November 23, 2009 (“BOX Letter”) at 1; Letter from Michael J. Simon, General Counsel, Secretary and Chief Regulatory Officer, International Securities Exchange, LLC (“ISE”), dated November 23, 2009 (“ISE Letter”) at 4.

1. Commenters argued that flash orders were necessary in the options markets to avoid the access fees that otherwise would be charged if the orders were routed to other exchanges. If the Commission adopted a cap on access fees for listed options, would the change remove the need for exchanges to use flash orders to prevent their customers from incurring high access fees? Would the reduction in benefits of flash orders for listed options go beyond the direct effect of the reduction in access fees, such as through an impact on spreads or order book liquidity? If so, how much weight should be given to this net reduction in benefits of flash orders in the Commission's analysis of the costs and benefits of the Proposal to eliminate the flash order exception for listed options?

2. Comment and data are requested on the execution quality, including implementation shortfall of latency or nonexecution, received by investor orders in listed options that are placed in a flash mechanism.<sup>13</sup> What percentage of such orders are executed in the flash mechanism (that is, by execution against a flash responder)? How do the average access fees paid by these flashed orders compare to the average access fees the orders would have paid if they had been routed to an exchange posting the best quote? For orders that do not receive an execution in the flash mechanism, what percentage are routed to other exchanges, and what percentage of orders routed to other exchanges receive an execution? What proportions of flashed orders that received a flash execution, or that were executed at other markets,

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<sup>13</sup> Implementation shortfall measures two components of order execution quality for marketable flash orders. First, for orders that are executed (whether at the flashing exchange or after routing to another exchange), it measures the difference between the trade price and the relevant quotation at the time of order receipt at the flashing exchange (the national best offer for buy orders and the national best bid for sell orders). Second, for orders that are cancelled without any execution or with only a partial execution, implementation shortfall measures the difference between the relevant quotation (as described for executed orders) and an imputed price based on the relevant quotation when the order is cancelled.

respectively, received an execution at a price better than, equal to, or worse than the national best bid or offer (“NBBO”) at the time of order receipt at the exchange that flashed the order? Are flash orders used more often in certain market conditions, such as at times with wider bid-ask spreads? If so, please divide the statistics above by those market conditions.

3. Comment and data are requested on the execution quality received by investor orders in listed options that are not flashed. To what extent do marketable orders receive executions at prices that are better than, equal to, or worse than the NBBO at the time of order receipt at the exchange that initially receives the order? We understand that execution quality statistics comparable to those requested above are not widely available to investors and brokers in the listed options markets. Are they available to any investors or brokers to assess the execution quality of flashed orders? To the extent that they are not available, how are investors and brokers able to assess execution quality for flashed orders? For example, if investors and brokers do not have execution quality statistics for non-flashed orders in the options markets, how would they be able to compare the execution quality of flashed orders with the execution quality of orders that are not flashed?

4. What steps do brokers take to assess whether flashed orders in listed options “miss the market” by failing to receive either any execution or an execution at the NBBO price when the flashing exchange initially received the order? What data or other objective evidence do brokers use to assess whether flashed orders receive best execution?<sup>14</sup>

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<sup>14</sup> The Commission notes that the “Recommendations for Quality of Execution Reports for Options Exchanges” issued by the SIFMA Equity Options Trading Committee on July 17, 2008 (“SIFMA Recommendations”) do not appear to provide relevant information on whether flashed orders miss the market. The SIFMA Recommendations specifically exclude orders that an exchange routes away for execution elsewhere from the exchange’s execution quality statistics. The SIFMA Recommendations are available at <http://www.sifma.org/assets/0/232/234/274/bbc1f723-af5b-45ed-b2f2-1ae7d2f2127d.pdf>.

5. One commenter suggested that only in “rare” instances do flashed orders that are routed away “miss the NBBO market,” and that in those rare instances the brokers typically honor the NBBO for their customers.<sup>15</sup> Do commenters agree with this statement? Does your answer depend on whether the NBBO benchmark that is honored is understood to be the NBBO at the time of order receipt at the flashing exchange, or the NBBO at some other time? Do commenters have any data to support their conclusion?

6. Several commenters stated that liquidity providers at “maker/taker” options exchanges quote more aggressively – that is, by displaying quotations that either improve the NBBO or are alone at the NBBO – because of the rebates paid to liquidity providers that are funded from the access fees charged to liquidity takers.<sup>16</sup> Do commenters agree that liquidity providers on maker/taker exchanges quote more aggressively than other exchanges once their displayed quotations are adjusted to account for the effect of access fees on the “all in” cost to the investor? If so, are liquidity rebates the only reason that liquidity providers on maker/taker exchanges are willing to quote aggressively? For example, does the absence of order flow captured by payments to routing brokers and the absence of guaranteed allocations for liquidity providers also contribute significantly to aggressive quoting by liquidity providers on maker/taker exchanges?

7. The Commission notes the distinction between “aggressive” quotations and “matching” quotations. Aggressive quotations are price leaders and help narrow the NBBO spread (by either improving the NBBO or remaining alone at the NBBO). Matching quotations follow prices set elsewhere and add size to the NBBO, but do not narrow the spread. To what

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<sup>15</sup> CBOE Letter at 5 n. 5.

<sup>16</sup> ISE Letter at 8; Letter from Larry Harris, Professor of Finance and Business Economics, USC Marshall School of Business, dated December 4, 2009 (“Harris Letter”) at 2.

extent do liquidity providers on payment for order flow options exchanges quote aggressively rather than merely matching the NBBO set elsewhere? Would eliminating the flash order exception lead one or both types of options exchange to quote more aggressively and thereby narrow NBBO spreads for listed options? Does your answer change depending on whether the Commission adopts a cap on access fees in the options markets that is substantially less than the access fees currently charged?

8. Does the availability of the flash mechanism at payment for order flow options exchanges play a significant role in enabling such exchanges to compete for order flow through broker payments, rather than through offering better prices for the execution of investor orders? Would eliminating the flash order exception lead payment for order flow options exchanges to respond competitively by more aggressive quoting or through greater use of price improvement mechanisms targeted at non-professional customer order flow?<sup>17</sup>

9. One commenter noted that there is no over-the-counter (“OTC”) trading in listed options and that, as a result, more “good” order flow (that is, order flow relatively uninformed about future prices) reaches the options exchanges than the cash equity exchanges.<sup>18</sup> Another noted that, because quotations must be available for execution to all incoming order flow – both informed and uninformed – the quotations must be wider than the prices that could be offered exclusively to uninformed order flow.<sup>19</sup> (Prices that could be offered exclusively to uninformed order flow could incorporate tighter spreads because the market maker does not need to protect itself from adverse selection by informed traders by building in a wider spread.) Do commenters

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<sup>17</sup> In general, a price improvement mechanism exposes incoming marketable orders to a competitive auction that provides an opportunity for the orders to be executed at better prices than the NBBO.

<sup>18</sup> ISE Letter, Appendix B at 2.

<sup>19</sup> Harris Letter at 4.

agree with these statements? If so, do mechanisms that offer price improvement attract a large percentage of customer order flow in listed options? Why or why not?

In this regard, what percentage of order flow in listed options participates in the price improvement mechanisms offered by exchanges? Is it less than 1% of order flow at most exchanges? Would the figure be higher if the Commission eliminated the flash order exception? Are there other reasons why price improvement mechanisms do not attract significant order flow? Do exchanges need more flexibility in distinguishing between informed and uninformed order flow as a means to offer better prices to customers that are not professional traders? Must price improvement mechanisms guarantee the NBBO to attract order flow?

10. What is the effect on order execution quality, as well as on the nature of competition in the options markets, of the absence of publicly available order execution quality data comparable to the data that is available for cash equities under Rule 605 of Regulation NMS? How do investors and customers assess best execution issues for flash orders in the absence of mandatory execution quality statistics?

### **III. Conclusion**

The Commission requests comment and data on the issues discussed above, as well as reiterating its discussion and all requests for comment in the Proposing Release with respect to listed options. It is reopening the comment period on the Proposal to obtain the advantage of the public's views on all these issues.

By the Commission.

Elizabeth M. Murphy  
Secretary

Dated: July 2, 2010