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Proposed Amendments to Rule 610 of Regulation NMS; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 242

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RIN 3235–AK62

Proposed Amendments to Rule 610 of Regulation NMS

AGENCY: Securities and Exchange Commission ("Commission").

ACTION: Proposed rule.

SUMMARY: The Commission is publishing for comment proposed amendments to Rule 610 under the Securities Exchange Act of 1934 ("Exchange Act") relating to access to quotations in listed options as well as fees for such access. The proposed rule would prohibit an exchange from imposing unfairly discriminatory terms that inhibit efficient access to quotations in a listed option on its exchange and establish a limit on access fees that an exchange would be permitted to charge for access to its best bid and offer for listed options on its exchange.

DATES: Comments should be received on or before June 21, 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.* Please include File No. S7–09–10 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 Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File No. S7–09–10. 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, NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 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: Jennifer Colihan, Special Counsel, at (202) 551–5642; Edward Cho, Special Counsel, at (202) 551–5508; or Brian O'Neill, Special Counsel, at (202) 551–5643, Division of Trading and Markets ("Division"), Commission, 100 F Street, NE., Washington, DC 20549–6628.

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I. Introduction

The Commission is proposing to strengthen the national market system for listed options by: (1) Prohibiting the imposition of unfairly discriminatory terms by a national securities exchange that inhibit efficient access to quotations in a listed option on its exchange; and (2) establishing a limit on the amount a national securities exchange would be permitted to charge to access the best bid or offer for listed options on its exchange. These proposed amendments would make the requirements for access to the listed options exchanges comparable to the requirements for access to markets that trade NMS stocks.[1] Further, they would address concerns expressed by certain market participants regarding access to options exchanges.[2]

A. Background

In 1975, Congress determined that the "linking of all markets" through communications and data processing facilities would "foster efficiency; enhance competition; increase the information available to brokers, dealers, and investors; facilitate the offsetting of investors' orders; and contribute to the best execution of investors' orders."[3] As such, Congress directed the Commission, through the enactment of Section 11A of the Exchange Act, to facilitate the establishment of a national market system ("NMS") to link together the multiple individual markets that trade securities. Congress intended the Commission to take advantage of opportunities created by new data processing and communications technologies to preserve and strengthen the securities markets.

As previously recognized by the Commission, for the NMS to fulfill its statutory objectives, fair and efficient access to each of the individual markets that participate in the NMS is essential.[4] One of the statutory NMS objectives, for example, is to assure the practicability of brokers executing investors' orders in the best market.[5] Another is to assure the efficient execution of securities transactions.[6] Neither of these objectives can be achieved if brokers cannot fairly and efficiently route orders to execute against the best quotations, wherever such quotations are displayed in the NMS.[7]

The Commission believes that intermarket price protection is essential in a marketplace such as that for listed options where multiple exchanges trade the same securities.[8] For this reason, the Commission in 1999 ordered the exchanges to jointly develop an NMS linkage plan for listed options.[9] The first such NMS plan, which began operation in 2002 ("2002 Linkage Plan"), included a requirement that its participant exchanges avoid trading through[10] better priced quotations displayed on other options exchanges and disseminated pursuant to the Options Price Reporting Authority Plan ("OPRA Plan"), as well as a mechanism by which

[1] *See* 17 CFR 242.610.

[2] *See infra* Section I.B and notes 34–40 and accompanying text.

[3] *See* Section 11A(a)(1)(D) of the Exchange Act, 15 U.S.C. 78k–1(a)(1)(D).

[4] *See* Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) ("NMS Adopting Release") at 37538.

[5] *See* Section 11A(a)(1)(C)(iv) of the Exchange Act, 15 U.S.C. 78k–1(a)(1)(C)(iv).

[6] *See* Section 11A(a)(1)(C)(i) of the Exchange Act, 15 U.S.C. 78k–1(a)(1)(C)(i).

[7] *See* NMS Adopting Release, *supra* note 4, at 37548.

[8] Eight exchanges currently offer options trading facilities and another exchange is anticipated to begin operations shortly. *See* Securities Exchange Act Release No. 61152 (December 10, 2009), 74 FR 66699 (December 16, 2009) (order approving C2 Options Exchange's application for registration as a national securities exchange).

[9] *See* Securities Exchange Act Release No. 42029 (October 19, 1999), 64 FR 57674 (October 26, 1999).

[10] A "trade-through" was defined as a transaction in an options series at a price that is inferior to the NBBO, but shall not include a transaction that occurs at a price that is one minimum quoting increment inferior to the NBBO provided a Linkage Order is contemporaneously sent to each Participant disseminating the NBBO for the full size of the Participant's bid (offer) that represents the NBBO. *See* Section 2(29) of the 2002 Linkage Plan. "NBBO" was defined as the national best bid and offer in an options series calculated by a Participant. *See* Section 2(18) of the 2002 Linkage Plan.

participating exchanges could seek satisfaction if an order was traded through.[11] In August 2009, the options exchanges implemented a new NMS plan ("Plan"),[12] approved by the Commission, which specifically requires that each participating exchange establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trading through better priced quotations displayed on other options exchanges and disseminated pursuant to the OPRA Plan ("trade-throughs").[13] Rule 608(c) of Regulation NMS requires the options exchanges to comply with the terms of the Plan and to enforce compliance with the Plan by their members and persons associated with their members, absent reasonable justification or excuse.[14] Further, each exchange adopted rules to implement the Plan that prohibit members from effecting trade-throughs, subject to certain enumerated exceptions.[15] The approach to trade-throughs under the Plan is similar to that taken by the Commission under Rule 611 of Regulation NMS, which requires that a trading center establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the execution of trades at prices inferior to protected quotations in NMS stocks displayed by other trading centers, subject to applicable exceptions.[16]

To satisfy the requirements of the trade-through provisions of the Plan and the exchanges' rules [17] (collectively referred to as "Trade-Through Rules"), an options exchange with a best bid or best offer that is inferior to another exchange's best quotation may choose to handle a pending incoming marketable order by: (1) Cancelling the order; (2) routing the order to another exchange displaying a better price; [18] or (3) providing an opportunity for its members, on their own behalf or on behalf of other market participants, to "step up" and trade with the order at a price at least equal to the better displayed price on an away exchange.[19]

In addition, broker-dealers have a duty of best execution.[20] A broker-dealer must carry out a regular and rigorous review of the quality of the options markets to evaluate its best execution policies, including the determination as to which options market it routes customer order flow.[21] The protection against trade-throughs undergirds the broker-dealer's duty of best execution by helping ensure that customer orders are not executed at prices inferior to the best quotations, but does not supplant or diminish the broker-dealer's responsibility for achieving best execution, including its duty to evaluate the execution quality of markets to which it routes customer orders.[22]

These regulatory obligations mean that broker-dealers responsible for routing customer orders, as well as customers making their own order-routing decisions, must have fair and efficient access to the best displayed quotations to achieve best execution of those orders, and the exchanges themselves must have the ability to execute orders against the displayed quotations of other exchanges.[23] Moreover, the benefits of intermarket price protection could be compromised if exchanges were able to charge substantial fees for accessing their quotations.[24]

Further, the Exchange Act authorizes the Commission to adopt rules assuring the fairness and usefulness of quotation information.[25] The wider the disparity in the level of fees among the different exchanges, the less useful and accurate are the displayed prices. For example, if two options exchanges displayed quotations to sell an option for $10.00 per contract, one exchange offer could

[11] *See* Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000) (order approving 2002 Linkage Plan). The OPRA Plan is a national market system plan approved by the Commission pursuant to Section 11A of the Exchange Act and Rule 608 thereunder. *See* Securities Exchange Act Release No. 17638 (March 18, 1981), 22 S.E.C. Docket 484 (March 31, 1981).

[12] This new Plan was designed, in part, to apply the Regulation NMS price-protection provisions to the options exchanges. *See* letter from Michael J. Simon, International Securities Exchange LLC ("ISE"), to Nancy M. Morris, Secretary, Commission, dated September 12, 2007, at 2–3.

[13] *See* Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) ("Plan Approval Order") and Section 5(a) of the Plan. A "trade-through" is defined in this new Plan as a transaction in an option series, either as principal or agent, at a price that is inferior to the best bid or offer in an option series that is displayed by an exchange, and is disseminated pursuant to the OPRA Plan. *See* Sections 2(1), 2(6), 2(14), 2(17), and 2(21) of the Plan.

[14] *See* 17 CFR 242.608(c).

[15] *See, e.g.,* ISE Rule 1901, NYSE Arca, Inc. ("NYSE Arca") Rule 6.94, and NASDAQ OMX PHLX, Inc. ("Nasdaq OMX Phlx") Rule 1084. Prior to the adoption of the new Plan, the options exchanges had in place rules addressing trade-throughs as required under the 2002 Linkage Plan. The exchanges revised these rules following the adoption of the new Plan to reflect the trade-through requirements in the new Plan.

[16] 17 CFR 242.611(a). To be protected, a quotation must be immediately and automatically accessible. *See* 17 CFR 242.600(b)(58) (defining the term "protected quotation" as any protected bid or protected offer); *see also* 17 CFR 242.600(b)(57). The term "protected bid" or "protected offer" means a quotation in an NMS stock that is displayed by an automated trading center, is disseminated pursuant to an effective national market system plan, and is an automated quotation that is the best bid or best offer of a national securities exchange, the best bid or best offer of The Nasdaq Stock Market, Inc., or the best bid or best offer of a national securities association other than the best bid or best offer of The Nasdaq Stock Market, Inc.

[17] *See* Section 5(a) of the Plan; *see also, e.g.,* ISE Rule 1901, NYSE Arca Rule 6.94 and Nasdaq OMX Phlx Rule 1084.

[18] To implement the choice of routing to another exchange to access a better-priced quotation, the options exchanges currently use private routing arrangements that provide for indirect access to quotations displayed by a particular options exchange through the members of that exchange. The Commission has stated its belief that the use of private linkages for routing will allow the exchanges to take advantage of new technology that allows for efficient routing and executions, and will give the exchanges greater flexibility for order handling. *See* Plan Approval Order, *supra* note 13, at 39364. The options exchanges complied with the requirements of the prior linkage plan by utilizing a stand alone system ("centralized hub") to send and receive specific order types. The centralized hub was a centralized data communications network that electronically linked the options exchanges to one another. The Options Clearing Corporation ("OCC") operated the centralized hub. *See id.*

[19] The Commission separately has proposed changes to Rule 602 of Regulation NMS that may affect these electronic "step-up" mechanisms, if adopted. *See* Securities Exchange Act Release No. 60684 (September 18, 2009), 74 FR 48632, 48633 (September 23, 2009) (File No. S7–21–09) ("Flash Order Proposal"). *See infra* notes 72–75 and accompanying text.

[20] A broker-dealer has a legal duty to seek to obtain best execution of customer orders. *See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.,* 135 F.3d 266, 269–70, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998); *Certain Market Making Activities on Nasdaq,* Securities Exchange Act Release No. 40900 (Jan. 11, 1999) (settled case) (citing *Sinclair v. SEC,* 444 F.2d 399 (2d Cir. 1971); *Arleen Hughes, 27 SEC 629, 636 (1948), aff'd sub nom. Hughes v. SEC,* 174 F.2d 969 (D.C. Cir. 1949)). *See also Order Execution Obligations,* Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) ("Order Handling Rules Release"). A broker-dealer's duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated in SRO rules and, through judicial and Commission decisions, the antifraud provisions of the federal securities laws. *See* Order Handling Rules Release, 61 FR at 48322. *See also* Newton, 135 F.3d at 270. The duty of best execution requires broker-dealers to execute customers' trades at the most favorable terms reasonably available under the circumstances, *i.e.,* at the best reasonably available price. *Newton,* 135 F.3d at 270. *Newton* also noted certain factors relevant to best execution—order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. *Id.* at 270 n.2 (citing Payment for Order Flow, Exchange Act Release No. 33026 (Oct. 6, 1993), 58 FR 52934, 52937–38 (Oct. 13, 1993) (Proposed Rules)). *See In re E.F. Hutton & Co.,* Securities Exchange Act Release No. 25887 (July 6, 1988). *See also* Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, 55008–55009 (November 2, 1994) ("Approval of Payment for Order Flow Final Rules"). *See also* NMS Adopting Release, *supra* note 4, at 37537 (discussing the duty of best execution).

[21] *See* Securities Exchange Act Release No. 49175 (February 3, 2004), 69 FR 6124, 6128 (February 9, 2004) ("Options Concept Release"). *See also* NMS Adopting Release, *supra* note 4, at 37538.

[22] *See* NMS Adopting Release, *supra* note 4, at 37538.

[23] *See id.* at 37539.

[24] *See id.* at 37544.

[25] *See* Section 11A(c)(1)(B) of the Exchange Act, 15 U.S.C. 78k–1(c)(1)(B).

be accessible for a total price of $10.00 per contract plus a $0.50 per contract access fee, while the second exchange might not charge any such access fee. What appeared in the consolidated data stream to be identical quotations would in fact not be identical in terms of all-in costs. The Commission recognizes that there may be different ways to achieve the objective of fair and useful quotations. One approach is to limit the extent to which the all-in price for those who access quotations can vary from the displayed price by limiting fees for accessing those quotations, as proposed here in Rule 610(c)(2).[26]

An access fee limit also creates more transparency in the cost of accessing quoted prices. Currently, there are so many different fees across options exchanges, across different categories of options participants, and across different product types, that it is not easy to estimate the total cost of executing against a quotation for a particular transaction. An access fee cap would provide clearer information on the maximum cost for accessing quoted prices. The Commission recognizes, however, that although a cap on access fees would promote the fairness and usefulness of displayed quotations and transparency in the cost of assessing quoted prices, there may be other fees assessed that would not be included in the proposed cap on access fees.

B. Overview of Current Options Market Structure

In the listed options market, all orders are currently executed on registered national securities exchanges. Options exchanges have, to date, adopted one of two general business models. An exchange using the first model—referred to as the "Make or Take" model—incents market participants to quote aggressively by providing a rebate to an order or quotation displayed on its exchange when such order or quotation is executed. This rebate is funded through the fee charged to the order that executed against the displayed order or quotation. The difference between the fee charged for accessing the order or quotation and the rebate is revenue to the exchange.

NYSE Arca was the first options exchange to implement the Make or Take transaction fee model.[27] The introduction of the Make or Take model followed the reduction of the quoting increment in certain options in 2007.[28] As of February 1, 2010, market participants could represent trading interest in penny increments in options series in 211 specified classes. These classes represent approximately 69.5 percent of trading volume. By August 2, 2010, 361 classes will be included in the Minimum Quoting Increment Pilot Program, representing approximately 88.1 percent of trading volume during February 2010.[29]

On an exchange with a "Make or Take" fee model, broker-dealers representing customer orders must pay a "Take" fee to access a displayed quotation on that exchange. In contrast, on an exchange without that fee model, broker-dealers generally are not assessed a similar fee when a customer order is executed. This distinction brought attention to the issue of whether, and to what extent, access fees impact fair and efficient access to displayed quotations in listed options.

Exchanges using the second model—referred to as the "Broker Payment" model—generally charge no or low fees for the execution of customers' orders.[30] However, these exchanges often charge other types of fees on a per-transaction basis. For example, most options exchanges charge a surcharge or "royalty" fee for executions in certain index option classes.[31] Many exchanges also charge a payment for order flow or "marketing" fee to market makers that trade with customer orders on the exchange.[32] The exchange then makes the proceeds from such fees available to

[26] *See* NMS Adopting Release, *supra* note 4, at 37545 (stating that for quotations to be fair and useful there must be some limit on the extent to which the true price for those who access quotations can vary from the displayed price).

[27] *See* Securities Exchange Act Release No. 55223 (February 1, 2007), 72 FR 6306 (February 9, 2007) (SR–NYSEArca–2007–07). The NASDAQ Options Market LLC ("NOM") also uses a "Make or Take" fee model for certain options classes. *See* The NASDAQ Options Market: Execution and Routing Fees (available at *http://www.nasdaqtrader.com/content/ProductsServices/PriceList/nasdaq_options_pricing.pdf*) (current as of December 1, 2009).

[28] On January 26, 2007, the then-existing six options exchanges implemented a pilot program to quote certain options series in thirteen classes in one-cent increments ("Minimum Quoting Increment Pilot Program"). The NASDAQ Stock Market LLC ("Nasdaq") became a participant in the Minimum Quoting Increment Pilot Program on March 31, 2008, when it commenced trading on NOM, and BATS Exchange, Inc. ("BATS") became a participant in the Minimum Quoting Increment Pilot Program on February 26, 2010 when it commenced trading on BATS Options Exchange Market. Since 2007, the Minimum Quoting Increment Pilot Program has been extended and expanded several times. *See, e.g.,* Securities Exchange Act Release Nos. 56276 (August 17, 2007), 72 FR 47096 (August 22, 2007) (SR–CBOE–2007–98); 56567 (September 27, 2007), 72 FR 56396 (October 3, 2007) (SR–Amex–2007–96); 57579 (March 28, 2008), 73 FR 18587 (April 4, 2008) (SR–Nasdaq–2008–026); 60711 (September 23, 2009), 74 FR 49419 (September 28, 2009) (SR–NYSEArca–2009–44); and 61061 (November 24, 2009), 74 FR 62857 (December 1, 2009) (SR–NYSEArca–2004–44).

[29] The source of the data is OptionsMetrics, LLC ("OptionsMetrics"). The data used for the estimates corresponds to February 2010. By August 2010, the Minimum Quoting Increment Pilot Program will incorporate 150 additional classes. Those classes will be incorporated according to volume levels on the month before the expansion. For the current approximation, Commission staff projected which classes would be added by August 2010 using volume data corresponding to February 2010.

[30] Exchanges that use the "Broker Payment" model also generally give priority to customer orders at the best price over other orders or quotations at that price. After customer orders are executed, the rules of "Broker Payment" options exchanges dictate how the remainder of an incoming order is allocated against resting non-customer orders or quotations. ISE, for example, requires that priority be given to public customer orders, and provides for pro-rata allocation among non-customer orders and quotations. *See* Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388, 11395 (March 2, 2000) (order approving the registration of the International Securities Exchange LLC as a national securities exchange ("ISE Exchange Approval")). Exchanges that use a "Broker Payment" model do not give priority to orders from certain customers who are "professional" customers under exchange rules. *See* Securities Exchange Act Release Nos. 59287 (January 23, 2009), 74 FR 5694 (January 30, 2009) (SR–ISE–2006–26); 61198 (December 17, 2009), 74 FR 68880 (December 29, 2009) (SR–CBOE–2009–078); and 61802 (March 3, 2010) (SR–Phlx–2010–05). "Professional" customers are treated on ISE, the Chicago Board Options Exchange, Incorporated ("CBOE"), and Nasdaq OMX Phlx in the same manner as a broker-dealer for purposes of specified order execution rules, including priority rules. Under these exchange rules, "Professional" customers participate in ISE's, CBOE's, and Nasdaq OMX Phlx's allocation processes on equal terms with broker-dealers, *i.e.,* they do not receive priority over broker-dealers in the allocation of orders on the exchange. Several exchanges have, however, begun to charge transaction fees to certain customers identified in exchange rules as "professionals." *See* Securities Exchange Act Release Nos. 59287 and 61198.

[31] *See* BOX Fee Schedule, at 1 (available at *http://www.bostonoptions.com/pdf/BOX_Fee_Schedule.pdf*) (current as of January 2010); CBOE Fee Schedule, at 1 (available at *http://www.cboe.com/publish/feeschedule/CBOEFeeSchedule.pdf*) (current as of February 2, 2010); ISE Fee Schedule, at 6 (available at *http://www.ise.com/assets//documents//Options Exchange//legal/fee/fee_schedule.pdf*) (current as of January 8, 2010); NYSE Amex Fee Schedule, at 3 (available at *http://www.nyse.com/pdfs/NYSE_Amex_Options_Fee_Schedule01.04.10.pdf*) (current as of January 4, 2010); NYSE Arca Fee Schedule, at 6 (available at *http://www.nyse.com/pdfs/NYSE_Arca_Options_Fee_Schedule1-08-2010.pdf*) (current as of January 8, 2010); and Nasdaq OMX Phlx Fee Schedule, at 5 (available at *http://www.nasdaqomxtrader.com/content/marketregulation/membership/phlx/feesched.pdf*) (current as of February 24, 2010).

[32] *See* CBOE Fee Schedule, at 2 (available at *http://www.cboe.com/publish/feeschedule/CBOEFeeSchedule.pdf*) (current as of February 2, 2010); ISE Fee Schedule, at 6 (available at *http://www.ise.com/assets//documents//Options Exchange//legal/fee/fee_schedule.pdf*) (current as of January 8, 2010); NYSE Amex Fee Schedule, at 3 (available at *http://www.nyse.com/pdfs/NYSE_Amex_Options_Fee_Schedule01.04.10.pdf*) (current as of January 4, 2010); NYSE Arca Fee Schedule, at 6 (available at *http://www.nyse.com/pdfs/NYSE_Arca_Options_Fee_Schedule1-08-2010.pdf*) (current as of January 8, 2010); and Nasdaq OMX Phlx Fee Schedule, at 6 (available at *http://www.nasdaqomxtrader.com/content/marketregulation/membership/phlx/feesched.pdf*) (current as of February 24, 2010).

the proceeds from such fees available to collectively fund payment for order flow to brokers directing order flow to the exchange.[33]

In July 2008 the Commission received a Petition for Rulemaking to Address Excessive Access Fees in the Options Markets from Citadel Investment Group, L.L.C. ("Citadel Petition").[34] In the Citadel Petition, Citadel petitions the Commission to engage in rulemaking to limit the "Take" fees that options exchanges may charge non-members to obtain access to quotations to $0.20 per contract. NYSE Arca also filed a proposal in July 2008 to raise its "Take" fee for certain classes. Specifically, NYSE Arca submitted a proposed rule change for immediate effectiveness that raised its "Take" fee charged to members for certain designated Minimum Quoting Increment Pilot Program issues from $0.45 per contract to $0.55 per contract, and raised the corresponding credit in those same issues from $0.30 per contract to $0.40 per contract for market makers, and from $0.25 per contract to $0.35 per contract for electronically executed broker-dealer and customer orders.[35] The Commission requested comment on the issue of access fees when it published NYSE Arca's proposal for comment.[36]

The Commission has received several comment letters in response to its request for comment on the NYSE Arca proposed rule change and to the Citadel Petition, which discuss the issue of access fees and imposing a cap on such fees.[37] The Commission also received several comment letters in response to a proposal to amend Rule 602 of Regulation NMS to effectively ban marketable "flash orders" in NMS securities that discuss the issue of access fees in listed options.[38] Commenters on the Flash Order Proposal expressed concern that eliminating flash orders on the options exchanges would increase direct costs associated with executing customers' listed options orders.[39] The absence of a limit on fees that an options exchange can charge for accessing its quotation was one reason commenters said that banning flash orders would be more detrimental to listed options customers than to cash equity customers.[40] These concerns about the absence of a limit on access fees on the listed options exchanges echo the comments received in response to the Citadel Petition and NYSE Arca's proposal. These comments were considered in developing this proposal and are discussed below.

II. Proposed Amendments to Rule 610(a)

Access to displayed quotations, particularly the best quotations of an exchange or association, is vital for the smooth functioning of intermarket trading.[41] Brokers responsible for routing their customers' orders, as well as investors that make their own order-routing decisions, must have fair and efficient access to the best displayed quotations of all options exchanges to achieve best execution of those orders. In addition, options exchanges themselves must have the ability to route orders for execution against the displayed quotations of other exchanges. Indeed, the concept of intermarket protection against trade-throughs is premised on the ability of options exchanges to trade with, rather than trade through, the quotations displayed by other options exchanges.[42]

Currently, Rule 610(a) furthers the goal of fair and efficient access to quotations primarily by prohibiting a national securities exchange or national securities association from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member of the national securities exchange or national securities association to any quotations in an NMS stock[43] displayed by the exchange or association.[44] This anti-discrimination standard is designed to support indirect access by persons to quotations in NMS stocks through members, and is

[33] *See, e.g.,* Nasdaq OMX Phlx Fee Schedule, at 6, 15 (available at *http://www.nasdaqomxtrader.com/content/marketregulation/membership/phlx/feesched.pdf*) (current as of February 24, 2010). *See also infra* note 109 and accompanying text.

[34] *See* letter from John C. Nagel, Managing Director & Deputy General Counsel, Citadel, to Nancy M. Morris, Secretary, Commission, dated July 15, 2008 (available at *http://www.sec.gov/rules/petitions/2008/petn4-562.pdf*).

[35] These Pilot issues included: AAPL, CSCO, DIA, MSFT, IWM, QQQQ, RIMM, XLF, SPY, YHOO. *See* Securities Exchange Act Release No. 58295 (August 4, 2008), 73 FR 46681 (August 11, 2008) (SR–NYSEArca–2008–75).

[36] Concurrently, NYSE Arca filed a proposed rule change to increase the fee charged to orders received through the then-existing options linkage in certain Minimum Quoting Increment Pilot Program issues from $0.45 to $0.55 per contract. *See* SR–NYSEArca–2008–76. The Commission has not published this proposed rule change for notice and comment. Pending Commission action on SR–NYSEArca–2008–76, NYSE Arca has stated that it will not implement its fee changes included in SR–NYSEArca–2008–75.

[37] Letters received in response to SR–NYSEArca–2008–75: *See* letters from John C. Nagel, Managing Director and Deputy General Counsel, Citadel, to Nancy M. Morris, Secretary, Commission, dated July 23, 2008 ("Citadel Letter"); Stephen Schuler and Daniel Tierney, Managing Members, Global Electronic Trading Company to Florence E. Harmon, Acting Secretary, Commission, dated September 2, 2008 ("GETCO Letter"); Christopher Nagy, Managing Director, Order Routing Sales and Strategy, TD Ameritrade, Inc. to Florence E. Harmon, Acting Secretary, Commission, dated September 9, 2008 ("TD Ameritrade Letter"); and Robert R. Bellick, Managing Director, Wolverine to Nancy M. Morris, Secretary, Commission, dated September 10, 2008 ("Wolverine Letter") (available at *http://www.sec.gov/comments/sr-nysearca-2008-75/nysearca200875.shtml*).

Letter received in response to the Citadel Petition: *See* letter from Lawrence Leibowitz, Group Executive Vice President and Head of Global Execution and Technology, NYSE Euronext, to Florence E. Harmon, Acting Secretary, Commission, dated September 3, 2008 ("NYSE Euronext Letter") (available at *http://www.sec.gov/comments/4-562/4-562.shtml*).

Letters received in response to both the Citadel Petition and SR–NYSEArca–2008–75: *See* letters from David M. Battan, Executive Vice President, Interactive Brokers Group LLC, to Florence Harmon, Acting Secretary, Commission, dated September 8, 2008 ("IB Letter"); and William Easley, Vice Chairman, Boston Options Exchange ("BOX") to Florence E. Harmon, Acting Secretary, Commission, dated September 11, 2008 ("BOX Letter") (available at *http://www.sec.gov/comments/sr-nysearca-2008-75/nysearca200875.shtml*).

Letters received in response to SR–NYSEArca–2009-44, which proposed to expand the number of classes eligible to participate in the Minimum Quoting Increment Pilot: *See* letters from Christopher Nagy, Managing Director, Order Routing Strategy, TD Ameritrade, Inc. to Elizabeth M. Murphy, Secretary, Commission, dated June 17, 2009 ("TD Ameritrade Letter II") and December 1, 2009 ("TD Ameritrade Letter III") (available at *http://www.sec.gov/comments/sr-nysearca-2009-44/nysearca200944.shtml*).

[38] *See* Flash Order Proposal, *supra* note 19. A "flash order" generally is any order qualifying for the "immediate execution or withdrawal" exception from Rule 602. For more detail about the basic features that define flash orders, see the Flash Order Proposal. Flash orders allow options exchanges that charge no or low fees to execute customer orders to "step up" and match better displayed quotations on other exchanges.

[39] *See, e.g.,* letters from Christopher Nagy, Managing Director, Order Routing Strategy, TD Ameritrade, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated November 23, 2009 ("Ameritrade Flash Letter"); letter from John C. Nagel, Managing Director and Deputy General Counsel, Citadel, to Elizabeth M. Murphy, Secretary, Commission, dated November 20, 2009 ("Citadel Letter II"); Peter Bottini, EVP Trading and Customer Service, and Hillary Victor, Associate General Counsel, optionsXpress, to Elizabeth M. Murphy, Secretary, Commission, dated November 25, 2009 ("optionsXpress Flash Letter"); Thomas F. Price, Managing Director, Securities Industry Financial Association, to Elizabeth M. Murphy, Secretary, Commission, dated December 1, 2009 ("SIFMA Flash Letter") (available at *http://www.sec.gov/comments/s7-21-09/s72109.shtml*).

[40] *See* SIFMA Flash Letter, *supra* note 39, at 5. *See also* Citadel Letter II, *infra* note 39, at 1–2; Ameritrade Flash Letter, *supra* note 39, at 3; and optionsXpress Flash Letter, *supra* note 39, at 6.

[41] *See* NMS Adopting Release, *supra* note 4, at 37539. Currently, no national securities association quotes or trades listed options.

[42] *See id.*

[43] *See* Rule 600(b)(47), 17 CFR 242.610(b)(47) (defining NMS stock as any NMS security other than an option). *See also* Rule 600(b)(46), 17 CFR 242.610(b)(46) (defining NMS security as any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options).

[44] *See* Rule 610(a), 17 CFR 242.610(a). *See also* NMS Adopting Release, *supra* note 4, at 37539.

premised on fair and efficient access of exchange or association members themselves to the quotations in NMS stocks.[45]

The Commission is proposing to amend Rule 610(a) to extend this prohibition to NMS securities,[46] which include listed options as well as NMS stocks. The proposal to extend the anti-discrimination standard in Rule 610(a) to the trading of listed options is designed to support indirect access by persons to quotations in listed options through members. Like current Rule 610(a), the proposed amendment is premised on the need for fair and efficient access of members themselves to the quotations of the exchange in listed options.

Market participants can either become members of an exchange to obtain direct access to its options quotations, or they can obtain indirect access by "piggybacking" on the direct access of members. Access to exchanges currently is addressed by several provisions of the Exchange Act.[47] In particular, Section 6(b)(5) of the Exchange Act requires in part that the rules of an exchange not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.[48] The proposed amendments to Rule 610(a) would build on this existing access structure, including the prohibition in Section 6(b)(5) against unfair discrimination, by specifically prohibiting unfair discrimination that prevents or inhibits non-members from "piggybacking" on the access of members. The ability to fairly and efficiently obtain indirect access through a member is necessary to assure that non-members can readily access quotations in options to meet the requirements of the Trade-Through Rules and to fulfill the non-members' duty of best execution.[49]

The Commission does not believe that, if it were to prohibit exchanges from imposing unfairly discriminatory terms on non-members who obtain indirect access to quotations in options through members, it would require exchanges to provide non-members with *free* access to such quotations. Members who provide piggyback access to non-members would be providing a useful service and presumably would charge a fee for such service. The fee would be subject to competitive forces and likely would reflect the costs of membership, plus some element of profit to the members. As a result, non-members that frequently make use of indirect access are likely to contribute indirectly to cover the costs of membership in the market. In addition, the unfair discrimination standard of Rule 610(a) as proposed to be amended would apply only to access to quotations in NMS securities, including options. All other services would be subject to the more general fair access provisions applicable to national securities exchanges, as well as the statutory provisions that govern their respective rules.[50]

On the other hand, any attempt by an options exchange to charge differential fees based solely on the non-member status of a person obtaining indirect access to its quotations would violate Rule 610(a) as proposed to be amended.[51] As noted above, fair and efficient access to quotations is essential to the functioning of the NMS.[52] For example, if an exchange charges discriminatory fees to non-members to access its quotations, this practice would interfere with the functioning of the private linkage approach and detract from its usefulness to exchanges in meeting their required responsibilities under the Trade-Through Rules. Fair and efficient access to the best quotations is also necessary for brokers to achieve best execution of orders.[53] Accordingly, the Commission is proposing to amend Rule 610(a) to establish baseline intermarket access rules for options markets to promote indirect access to such markets by a non-member through a member.

The prohibition on imposing unfairly discriminatory terms in Rule 610(a) currently applies to terms that prevent or inhibit efficient access to quotations. The term "quotation" is defined in Rule 600(a)(62) of Regulation NMS as a bid or offer, and "bid" or "offer" is defined in Rule 600(b)(8) of Regulation NMS as the bid price or the offer price communicated by a member of a national securities exchange or national securities association to any broker or dealer or to any customer.[54] Rule 610(a), therefore, applies to the entire depth of book of displayed orders in NMS stocks, including reserve size[55] and displayed size at each price.[56] The Commission's proposal to extend Rule 610(a) to all NMS securities so that listed options markets are covered by the Rule would apply in the same manner.[57] Thus, options markets would be prohibited from imposing unfairly discriminatory terms that prevent or inhibit efficient access to the entire depth of book of displayed orders.

III. Access Fees

A. Proposed Rule 610(c)(2)

Generally, the Commission believes that market forces and the dynamics of competition should determine the level of exchange fees whenever possible.[58] As discussed below, however, the Commission is concerned that because of the requirements for intermarket price protection, competitive forces, by themselves, are not, and will not be, enough to prevent fees from being charged that interfere with fair and

[45] *See* NMS Adopting Release, *supra* note 4, at 37502.

[46] *See supra* note 43 (defining NMS security).

[47] Section 6(b)(4) of the Exchange Act requires the rules of an exchange to provide for the equitable allocation of reasonable dues, fees, and other charges among its members and other persons using its facilities, while Section 6(b)(5) of the Exchange Act requires in part that its rules not be designed to permit unfair discrimination between customers, brokers, or dealers. Section 6(b)(5) also requires an exchange to have rules designed to remove impediments to, and perfect the mechanism of, a free and open market and a national market system. In addition, Section 6(b)(1) of the Exchange Act requires that an exchange must have the capacity to be able to carry out the purposes of the Exchange Act. *See* 15 U.S.C. 78f(b)(4); 15 U.S.C. 78f(b)(5); 15 U.S.C. 78f(b)(1). Section 11A(a)(1)(C) of the Exchange Act provides that two of the objectives of a national market system are to assure the economically efficient execution of securities transactions and the practicability of brokers executing investors' orders in the best market. *See* 15 U.S.C. 78k–1(a)(1)(C).

[48] The requirements of Section 6(b)(5) of the Exchange Act apply to any rule of an exchange, and as such are not limited to access through members of an exchange to the quotations of that exchange.

[49] *See supra* notes 4–22 and accompanying text.

[50] *See* NMS Adopting Release, *supra* note 4, at 37540.

[51] *Id.* For example, the Commission preliminarily believes an exchange that charges a non-member broker-dealer that is registered as an options market maker on another exchange a higher fee than the fee charged to both member and non-member broker-dealers that also are not market makers on that exchange for obtaining access to its quotations would violate Rule 610(a), as proposed to be amended.

[52] *See supra* notes 4–7 and accompanying text.

[53] *See* NMS Adopting Release, *supra* note 4, at 37539. *See also supra* notes 20–22 and accompanying text.

[54] *See* 17 CFR 242.600(b)(62) and 17 CFR 242.600(b)(8).

[55] "Reserve size" generally means an undisplayed portion of an order. Once the displayed size of an order is executed against, the reserve size is used to refresh the market participant's displayed size. *See, e.g.,* NYSE Arca Rule 6.62(d)(3) and ISE Rule 2104(n).

[56] *See* NMS Adopting Release, *supra* note 4, at 37548.

[57] The Commission notes that, although fees are the most likely way in which an exchange could discriminate against non-members for access to its quote, the Commission's proposal would more broadly prohibit *any* unfairly discriminatory terms.

[58] *See* Securities Exchange Act Release Nos. 59039 (December 2, 2008), 73 FR 74770, 74781–82 (December 9, 2008) ("NYSE Arca Data Order") (stating in part that "[t]he Exchange Act and its legislative history strongly support the Commission's reliance on competition, whenever possible, in meeting its regulatory responsibilities for overseeing the SROs and the national market system. Indeed, competition among multiple markets and market participants trading the same products is the hallmark of the national market system.").

efficient access to an option exchange's displayed prices.[59] Accordingly, the Commission is proposing to impose a limit on the amount of fees that an exchange can impose (or permit to be imposed) for the execution of an order against the exchange's best bid and offer. This proposal also responds to market participants' concerns regarding access fees,[60] as discussed below.[61]

Each of the options exchanges currently charges market participants fees when incoming orders access their displayed quotations. Although these fees may have different names (*e.g.,* a "Take" fee versus a transaction fee), and may vary in amount based on the type of account from which the order is sent, these fees all have one thing in common—they are fees triggered by the execution of an incoming order against an order or quotation on that exchange.

In particular, on exchanges that use the "Broker Payment" fee model,[62] although orders executed on behalf of customer accounts may not be charged any transaction fees, orders executed on behalf of non-customer accounts are charged transaction fees.[63] In some cases, these fees may be substantial. For example, for options classes not included in the Minimum Quoting Increment Pilot Program, one exchange charges $0.50 per contract for electronically executed orders for the account of a broker dealer or firm,[64] while another exchange charges $0.45 per contract for electronically executed broker-dealer orders.[65]

In addition, on exchanges that use the "Make or Take" fee model,[66] an exchange charges "Take" fees to members that execute orders against that exchange's quotations. These exchanges then pass a substantial portion of that fee back as a rebate to the member that supplied the accessed liquidity (*i.e.,* market maker quotations or non-marketable limit orders). The "Take" fees charged by these exchanges also can be substantial. For example, for options classes in the Minimum Quoting Increment Pilot Program, one exchange charges $0.45 per contract when an order for the account of a non-customer (and $0.35 per contract when an order for the account of a customer) trades against liquidity on the exchange's book. The exchange then rebates $0.25 per contract to the member (or members) that represented the order (or orders) on its book that provided the liquidity to the incoming order.[67] Another exchange charges a $0.45 per-contract "Take" fee when an order in a Minimum Quoting Increment Pilot Program options class trades with liquidity on the exchange's book. This exchange then rebates $0.30 per contract to an exchange market maker that provided the liquidity to the incoming order and $0.25 per contract to the member that represented a broker-dealer or customer order that provided liquidity to the incoming order.[68]

The Commission believes that the benefits of intermarket price protection and more efficient linkages could be compromised if options exchanges charge substantial fees for accessing their best bids and offers. For this reason, the Commission preliminarily believes that a fee limitation is necessary to support the integrity of the price protection requirement under the Trade-Through Rules.[69] The Commission's views are informed by commenters that argue that a limit on fees for accessing quotations would support the integrity of the rules limiting trade-throughs because a fee limitation would prohibit individual exchanges from raising their fees substantially in an attempt to take improper advantage of protection against trade-throughs. In particular, commenters contend that, in the absence of a fee limit, some exchanges may take advantage of the requirement to protect displayed quotations by charging exorbitant fees to those required to access the exchange's quotations, which could compromise the fairness and efficiency of the NMS for trading standardized options.[70] Although the exchange charging the highest fees likely would be the last exchange to which orders would be routed, prices could not move to the next level until someone routed an order to take out the displayed price at such a high fee exchange. Thus, while exchanges would have significant incentives to compete to be near the top in order-routing priority, arguably there would be little incentive to avoid being the least-preferred exchange if fees were not limited.[71]

The proposed fee limitation is designed to preclude this business practice by limiting individual exchanges from having fee structures that take improper advantage of the required protection against trade-throughs and undermine the overall benefits of the new private routing regime. It also would preclude an options exchange from charging excessively high fees selectively to competitors.

[59] *See* NMS Adopting Release, *supra* note 4, at 37545 (concluding that imposing a fee limitation was necessary to support the integrity of the price protection requirement established to prevent trade-throughs: "[T]he adopted fee limitation is designed to preclude individual trading centers from raising their fees substantially in an attempt to take improper advantage of strengthened protection against trade-throughs and the adoption of a private linkage regime. In particular, the fee limitation is necessary to address "outlier" trading centers that otherwise might charge high fees to other market participants required to access their quotations by the Order Protection Rule.").

[60] These concerns, as noted above, have been raised by a petition for rulemaking to limit the "Take" fees that options exchanges may charge non-members to access quotations and comment letters in response to this petition and NYSE Arca's proposal to raise its "Take" fee. *See* Citadel Petition, *supra* note 34; *see also supra* note 37.

[61] *See infra* notes 70 and 79 and accompanying text.

[62] *See supra* notes 30–33 and accompanying text.

[63] A customer generally is understood to be a person that is not a broker-dealer. *See, e.g.,* ISE Rule 100(a)(38) (defining the term "public customer"). However, as noted above, some exchanges have begun to charge transaction fees to certain customers identified in exchange rules as "professionals." *See supra* note 30.

[64] *See* NYSE Arca Fee Schedule (available at *http://www.nyse.com/pdfs/NYSE_Arca_Options_Fee_Schedule1-08-2010.pdf*) (current as of January 8, 2010).

[65] *See* CBOE Fee Schedule (available at *http://www.cboe.com/publish/feeschedule/CBOEFeeSchedule.pdf*) (current as of February 2, 2010).

[66] *See supra* note 27 and accompanying text.

[67] *See* Section 1 of Nasdaq Rule 7050 and The NASDAQ Options Market: Execution and Routing Fees (available at *http://www.nasdaqtrader.com/content/ProductsServices/PriceList/nasdaq_options_pricing.pdf*) (current as of January 4, 2010).

[68] *See* "Transaction Costs" Section of the NYSE Arca Fee Schedule (available at *http://www.nyse.com/pdfs/NYSE_Arca_Options_Fee_Schedule1-08-2010.pdf*) (current as of January 8, 2010). *See also supra* notes 35 and 36 and accompanying text.

[69] *See supra* notes 13 and 17–19 and accompanying text for a definition of "Trade-Through Rules."

[70] *See* Citadel Petition, *supra* note 34, at 4 (arguing that "Taker" fees are sustained by virtue of the regulatory obligations prohibiting trade-throughs, in that when an exchange is quoting alone at the NBBO, market participants cannot avoid the Taker fees imposed by such exchange, irrespective of how high such fees may be); Citadel Letter II, *supra* note 37, at 6 (arguing that if the Commission were to ban or limit the use of step-up mechanisms in the options markets, the need for an access fee cap would become essential); TD Ameritrade Letter, *supra* note 37, at 1 (arguing that Make or Take fees have the potential to create incentives for participants to post liquidity and lock markets to capture the rebate and that other options exchanges would have to increase their fees and rebates in order to defend their market share). *See also* Wolverine Letter, *supra* note 37, at 6 (asserting that, while a cap implemented as proposed by Citadel would reduce Take fees charged to *non-members* who may be forced to access "outlier" markets due to trade through obligations, *members* would still be forced to pay unrestricted fees); GETCO Letter, *supra* note 37, at 3 (stating that if the Commission does decide to place caps on access fees charged by exchanges that use the "Make or Take" fee model, it should also cap all-in access fees for traditional exchanges, *i.e.,* those that use the "Broker Payment" fee model, regardless of the type of market participant accessing the exchange's quotation).

[71] *See* NMS Adopting Release, *supra* note 4, at 37545.

The Commission notes that several exchanges have rules that allow—and encourage—their members to electronically "step up" and match a better-priced bid or offer available on another exchange—a "flash" functionality—rather than send orders to other exchanges for execution.[72] These exchanges stated that they implemented this "flash" functionality because of the high costs associated with routing an order to away exchanges to be executed, particularly one with a Make or Take fee model.[73]

The Commission separately has proposed changes to Rule 602 of Regulation NMS that may affect these electronic "step-up" mechanisms, if adopted.[74] There are structural differences between the listed options exchanges and the cash equity markets that commenters identified as making the use of "flash" orders on the options exchanges serve a different purpose. In particular, commenters stated that eliminating the ability of market participants on the options exchanges to "step up" to better prices on other exchanges through the use of "flash" orders could impose significant costs on retail options customers whose orders would be routed to other options exchanges because, in part, of the absence of any limits on the fees options exchanges may charge to access their quotations.[75]

The Commission also believes that for quotations to be fair and useful, there must be some limit on the extent to which the all-in price for those who access quotations can vary from the displayed price.[76] The wider the disparity in the level of fees among the different exchanges, the less useful and accurate are the displayed prices. For example, if two options exchanges displayed quotations to sell an option for $10.00 per contract, one exchange offer could be accessible for a total price of $10.00 per contract plus a $0.50 per contract access fee, while the second exchange might not charge any such access fee. What appeared in the consolidated data stream to be identical quotations in terms of all-in costs would in fact not be identical. Access fees tend to be highest when exchanges use them to fund substantial rebates to liquidity providers, rather than merely to compensate for agency services.[77] These concerns were also expressed by several commenters who argue that for quotations to be fair and useful, there must be some limit to the extent to which the displayed price can vary from the "all-in" price[78] of a quotation.[79] If exchanges were allowed to charge exorbitant fees and pass most of them through as rebates, the published quotations of such exchanges would not reliably indicate the all-in price actually available.

Section 11A(c)(1)(B) of the Exchange Act authorizes the Commission to adopt rules assuring the fairness and usefulness of quotation information. For quotations to be fair and useful, there must be some limit on the extent to which the all-in price for those who access quotations can vary from the displayed price. An access fee limit also creates more transparency in the cost of accessing quoted prices. Currently, there are so many different fees across options exchanges, across different categories of options participants, and across different product types, that it is not easy to estimate the total cost of executing against a quotation for a particular transaction. An access fee cap would provide clearer information on the maximum cost for accessing quoted prices. Consequently, the proposed fee limitation would further the statutory purposes of the Exchange Act by precluding the distortional effects of access fees.

The Commission preliminarily believes that to fully support the integrity of the price protection requirement in the Trade-Through Rules and to achieve the goals that an exchange's displayed quotations be fair and useful and reliably represent the all-in prices that are actually available to investors, the proposed fee limitation should apply to *any* fee, no matter what it is called,[80] charged to *any* person[81] for the execution of an incoming order against an options exchange's best bid and offer. As discussed above, the Commission believes that the benefits of intermarket price protection and more efficient linkages could be compromised if options exchanges charge substantial fees for accessing their best bids and offers. The proposed fee limitation is designed to preclude individual exchanges from having fee structures that take improper advantage of the required protection against trade-throughs and undermine the overall benefits of the new private routing regime. It also would preclude an options exchange from charging excessively high fees selectively to competitors. In this regard, the Commission preliminarily believes that limiting the proposed fee cap to apply to only one type of fee charged (for instance, only to "Take" fees), or limiting the proposed fee cap to fees charged only to certain persons (for example, only to non-members) by an options exchange for execution against

[72] *See, e.g.,* ISE Rule 803, Supplementary Material .02 and Securities Exchange Act Release Nos. 57551 (March 25, 2008), 73 FR 16917 (March 31, 2008) (SR–ISE–2008–28) and 58038 (June 26, 2008), 73 FR 38261 (July 3, 2008) (SR–ISE–2008–50). *See also* ISE Fee Schedule, *supra* note 32, at 3–4 (as an inducement to step-up and avoid routing to away markets, ISE waives the transaction fee for members when they execute against a public customer order that is exposed pursuant to ISE Rule 803, *i.e.,* ISE's step-up mechanism) (current as of January 8, 2010).

[73] *See, e.g.,* letters from William J. Brodsky, Chairman and Chief Executive Officer, CBOE, to Elizabeth M. Murphy, Secretary, Commission, dated November 18, 2009, at 2 (comment to Flash Order Proposal) ("CBOE Flash Letter"); Michael J. Simon, Secretary, ISE, to Elizabeth Murphy, Secretary, Commission, dated November 23, 2009 at 5 (comment to Flash Order Proposal) ("ISE Flash Letter"); Tony McCormick, CEO, BOX, to Elizabeth M. Murphy, Secretary, Commission, dated November 23, 2009, at 3 (comment to Flash Order Proposal). *See also* Securities Exchange Act Release Nos. 57551 (March 25, 2008), 73 FR at 16917 (March 31, 2008) (SR–ISE–2008–28) and 57937 (June 6, 2008), 73 FR 33865 (June 13, 2008) (SR–CBOE–2008–58) (relating to electronic exposure on HAL).

[74] *See* Flash Order Proposal, *supra* note 19.

[75] *See* SIFMA Flash Letter, *supra* note 39, at 5; Ameritrade Flash Letter, *supra* note 39, at 3; optionsXpress Flash Letter, *supra* note 39, at 6; and Citadel Letter II, *supra* note 39, at 6 (arguing that if the Commission were to ban or limit the use of step-up mechanisms in the options markets, the need for an access fee cap would become essential).

[76] *See* NMS Adopting Release, *supra* note 4, at 37545.

[77] *Id.* at 37544.

[78] The term "all-in" price is intended to capture the total costs for executing a trade. *See infra* note 90 and accompanying text.

[79] *See* BOX Letter, *supra* note 37, at 5–6 (stating its agreement with Citadel and the Commission that "[f]or quotations to be fair and useful, there must be some limit on the extent to which the true prices for those who access quotations can vary from the displayed price"); Citadel Petition, *supra* note 34, at 3–5 (arguing that markets employing a Make or Take fee model are charging excessive fees to obtain access to their quotations and, as a result, are causing distortions in such quotations, which should otherwise reliably represent the true prices actually available to investors.); NYSE Euronext Letter, *supra* note 37, at 3 (stating generally that they are in favor of rules that ensure the reasonableness of fees, similar to rate caps that were enacted in the equities markets in Regulation NMS); TD Ameritrade Letter, *supra* note 37, at 1–2; and Wolverine Letter, *supra* note 37, at 6 (asserting that unrestricted fees that members would have to pay would result in executions at prices materially different from the displayed quotations and, as a consequence, run contrary to the purposes behind the trade-through rules and the principles of best execution).

[80] *See* NYSE Euronext Letter, *supra* note 37, at 3 (stating that access fees should be addressed not as one model versus the other, but as a fee to access the market independent of the market structure that marketplace employs).

[81] *See* Wolverine Letter, *supra* note 37, at 6 (asserting that, while a proposed fee cap would reduce Take fees charged to non-members forced to access "outlier" markets at the NBBO due to trade-through obligations, members would still be forced to pay unrestricted fees) and GETCO Letter, *supra* note 37, at 3 (stating that if the Commission does decide to place caps on access fees charged by exchanges using the "Make or Take" fee model, it should also cap all-in access fees for traditional exchanges, regardless of the type of market participant accessing the exchange's quotation).

the exchange's best bid and offer would not fully achieve these objectives because it would not cover all fees that could be charged for access to the exchange's best quotation.

The Commission has received comments that the Make or Take fee structure exerts competitive pressure on the "traditional" fee structure where market makers pay brokers for order flow, and that imposing a cap on Take fees would limit the ability of exchanges that employ a Make or Take model to compete effectively with other exchanges that employ a Broker Payment model, to the detriment of investors.[82] The Commission supports the development of competing market models, as long as they are consistent with the requirements of the Exchange Act. An exchange could not, however, engage in conduct that is otherwise inconsistent with the requirements of the Exchange Act,[83] even if doing so would help that exchange to compete. As discussed above, the Commission preliminarily believes that the benefits of intermarket price protection and more efficient linkages could be compromised if options exchanges charge substantial fees for accessing their best bids and offers, and that a fee limitation is necessary to support the integrity of the price protection requirement under the Trade-Through Rules, but it requests comment on this issue.[84] The Commission also believes that for quotations to be fair and useful, there must be some limit on the extent to which the all-in price for those who access quotations can vary from the displayed price.[85] The Commission preliminarily believes that adopting an access fee limit of $0.30 per contract for option exchanges, regardless of their particular market structure, would not compromise the competitive viability of exchanges employing a Make or Take fee structure because it preliminarily believes that the proposed level of fee cap would provide those exchanges with sufficient flexibility to structure their fees and rebates to support their market model.[86] Although the Commission preliminarily believes that the proposed fee limit would continue to allow for competition among the options exchanges, it requests comment on this issue and comment on other ways to achieve the Commission's objectives.[87]

The Commission preliminarily believes that a limitation on access fees of $0.30 per contract (equal to $0.003 per share) would be a fair and appropriate solution. In the Commission's preliminary view, limiting access fees to $0.30 per contract would promote intermarket access, standardization of quotations, and the Commission's goals for an effective and efficient linkage between and among the options exchanges. The proposed fee limitation would place all options exchanges on a level playing field in terms of the fees they can charge for the execution of incoming options orders against their best bid and offer. Some exchanges might choose to charge lower fees, thereby increasing their ranking in the preferences of order routers; others might charge the full $0.30 per-contract fee and rebate a substantial portion to liquidity providers. The Commission preliminarily believes that competition would ultimately determine which strategy is most successful.

The Commission recognizes, however, that even though it is not proposing to prohibit an exchange from employing any particular market model, the proposed fee limitation may impact different market models in different ways. An exchange with a Make or Take fee model that currently charges a Take fee in excess of the proposed fee cap would take in less revenue per contract from a reduced Take fee, while an exchange with a Broker Payment fee model that charges a transaction fee in excess of the proposed fee cap would take in less revenue per contract from a reduced transaction fee. These reduced fees for accessing an exchange's best bid or offer, standing alone, might have an impact on the manner in which broker-dealers and other market participants, including the exchanges, route order flow. The exchange with the Make or Take fee model, however, might choose to recoup some of that revenue by reducing its Make rebate, which may have an impact on the quoting behavior of market participants that provide liquidity on that exchange. An exchange with a Broker Payment model might choose to recoup some of the revenue by amending other fees charged to its members, which might impact the order routing or other behavior of those members (and the members' customers), depending upon the type of fee change. Accordingly, although the Commission preliminarily believes that the proposed fee limit would allow for vigorous competition among the options exchanges, it requests comment on the impact of the proposed fee limit on the different exchanges' and market participants' behavior.[88]

The Commission is proposing to set a flat fee cap of $0.30 per contract (the equivalent of $0.003 per share). The Commission is not proposing to establish a cap for low-priced options based on a percentage of the options' price, similar to the existing fee cap of 0.3 percent of the quotation price per share for NMS stocks. The Commission's proposal is based on its preliminary view that the $0.30 per-contract level is consistent with the maximum fee limit for NMS stocks under Rule 610(c). The experience of the markets trading NMS stocks in recent years suggests that a fee cap of $0.30 per 100 shares did not prevent markets using a Make or Take fee model from competing effectively in a market where some participants engage in payment for order flow.[89] In addition, this access fee cap level would help ensure that the "all-in" fee[90] would be below the $1 minimum quoting increment[91] so that the quotations displayed in the NBBO indicate the best prices. For example, having a $0.30 cap[92] would help ensure that an offer of $2 is not inferior to an offer of $2.01 once access and other per-contract fees were added to the price. Stated another way, the Commission preliminarily believes that setting the proposed fee cap at $0.30 per contract would allow options exchanges flexibility to generate revenues from access fees while still providing the exchange the ability to continue to charge other fees, such as "licensing" fees charged by exchanges for executions in certain index

[82] *See* BOX Letter, *supra* note 37, at 2–3; IB Letter, *supra* note 37, at 2–3; and GETCO Letter, *supra* note 37, at 3.

[83] *See* 15 U.S.C. 78f(b) and 15 U.S.C. 78s(g).

[84] *See supra* note 69 and accompanying text.

[85] *See supra* note 76 and accompanying text. *See also* NMS Adopting Release, *supra* note 4, at 37545.

[86] *See infra* Section VIII.A.2 (discussing the impacts of the proposed amendments to Rules 610(a) and (c) on competition). *See also infra* notes 89 and 172 and accompanying text (noting that the experience of the markets trading NMS stocks in recent years suggests that a fee cap of $0.30 per 100 shares did not prevent markets using a Make or Take fee model from competing effectively in a market where some participants engage in payment for order flow).

[87] *See infra* Sections V (Request for Comment) and VIII.A.2 (discussing the impacts of the proposed amendments to Rules 610(a) and (c) on competition).

[88] *See infra* Sections V (Request for Comment) and VIII.A.2 (discussing the impacts of the proposed amendments to Rules 610(a) and (c) on competition).

[89] *See infra* note 172 and accompanying text.

[90] The "all in" fee for transactions in options contracts may include multiple charges such as "Take" fees or transaction fees, routing fees, and licensing fees. *See supra* note 78.

[91] Since every options quotation represents a cost equal to 100 times its price, a penny increment—the smallest possible increment for certain options—equals $1.00 in option cost.

[92] A $0.30 per-contract access fee is equal to a fee of $0.003 per underlying share.

options[93] or routing fees,[94] without exceeding the $1 minimum increment.

The Commission preliminarily believes that a flat $0.30 per-contract fee cap for all options would strike the appropriate balance between imposing a cap to carry out the objectives discussed above and providing options exchanges flexibility to compete with one another.[95] The Commission preliminarily does not believe that a cap for low-priced options should be based on a percentage of the quotation price as it is for low-priced NMS stocks. The Commission preliminarily believes that differences in the markets for NMS stocks and listed options merit this distinction. First, if an NMS stock is trading at a very low price, the access fee can become significant as a percentage of the total economic exposure. This result is less likely for listed options, given the leverage implicit in an option contract. For example, if an NMS stock is trading for $0.01 per share, so that an order for 100 shares represents $1 worth of stock, an access fee of $0.30 for 100 shares would represent thirty percent of the total economic position. On the other hand, an NMS stock priced at $10 per share could have a short-term out-of-the-money option priced at $0.01. If the Delta[96] of this option is 0.05, then one option contract would cost $1 but would give the investor exposure equivalent to an investment of $50 of the stock. An access fee of $0.30 per contract for the option would represent only six-tenths of one percent of the economic position.[97]

Second, the restriction on subpenny quoting in NMS stocks does not apply to stocks priced below $1.[98] Thus, for certain low-priced NMS stocks, an access fee of $0.003 per share could be larger than the minimum quoting increment, making it possible for an order to be routed to an exchange quoting a better price but ending up with an inferior all-in price after the access fee. For NMS stocks, the percentage fee cap for stocks priced below $1 helps to mitigate this concern. Because listed options are not currently quoted in subpenny increments, these concerns are not present, and, therefore, the Commission preliminarily believes it is unnecessary to establish a cap based on a percentage of the options' price for low-priced options. Further, if the Commission were to propose a percent-based fee cap for low-priced options, the access fee cap would be, in some cases, less than the amount of the "licensing" fees charged by exchanges for executions in certain index options.

Finally, a significant percentage of options contract trading volume is in lower priced options.[99] Thus, the Commission estimates that imposing a flat $0.30 per-contract cap, and not including a percentage fee cap for low-priced options similar to the existing fee cap of 0.3 percent of the quotation price per share for NMS stocks, would result in less potential revenue loss for options exchanges from the impact of the proposed fee cap and, therefore, possibly reduce the need for the options exchange to impose other fees on market participants.[100]

B. Terms of Proposed Rule 610(c)(2)

Under proposed Rule 610(c)(2), a national securities exchange would be prohibited from imposing, or permitting to be imposed, any fee or fees that exceeds or accumulates to more than $0.30 per contract for the execution of an order against any quotation in an option series that is the best bid or best offer of such national securities exchange. Thus, when triggered, the proposed fee limitation would apply to any order execution at the displayed price of the best bid or offer and would therefore encompass executions of orders against both the displayed size and any reserve size at the price of those quotations. Further, proposed Rule 610(c)(2) would apply to any fee based on the execution of an incoming order against an exchange's best bid or offer, such as a "Take" fee or other "transaction" fee charged by the exchange when an incoming order executes against the best bid or offer of the exchange. The Commission preliminarily believes that the proposed fee limitation would apply to other types of fees charged by an exchange to a member who represents an incoming order that trades against the exchange's best bid or offer.

For example, the proposed fee limitation would apply to fees charged by various exchanges for the execution of orders in certain options on indexes (called "licensing" or "index surcharge" or "royalty" fees) when the fee is charged for the execution of an incoming order against the exchange's best bid or offer. The proposed fee limitation also would apply to options regulatory fees ("ORF"), such as those that have been adopted by several exchanges.[101] For those exchanges that have adopted an ORF, the fee is charged on a per-contract basis and is assessed on each member for all options transactions executed or cleared by the member in a customer account. Because an ORF would constitute a fee for accessing the best bid or offer of an options exchange when such fee is assessed on a customer order that trades with the exchange's best bid or offer, the ORF would be covered by the proposed amendments to Rule 610(c)(2). So long as the fees are based on the execution of orders against the best bid or offer of the exchange, the proposed restriction in Rule 610(c)(2) would apply. Conversely, fees not triggered by the execution of orders against such quotations (*e.g.,* certain periodic fees

[93] These "licensing" fees generally do not exceed $0.22 per contract. *See, e.g.,* CBOE Fee Schedule (available at *http://www.cboe.com/publish/feeschedule/CBOEFeeSchedule.pdf*) (current as of February 2, 2010); and NYSE Arca Fee Schedule (available at *http://www.nyse.com/pdfs/NYSE_Arca_Options_Fee_Schedule1-08-2010.pdf*) (current as of January 8, 2010).

[94] Fees charged by options exchanges for routing orders to execute on other exchanges range from $0.00 to $0.95 per contract. *See* NYSE Arca Fee Schedule (available at *http://www.nyse.com/pdfs/NYSE_Arca_Options_Fee_Schedule1-08-2010.pdf*) (current as of January 8, 2010); and CBOE Fee Schedule (available at *http://www.cboe.com/publish/feeschedule/CBOEFeeSchedule.pdf*) (current as of March 16, 2010) (CBOE charges a $0.50 per contract fee for routing non-customer orders in addition to the customary CBOE execution charge, which for electronic orders for broker-dealers is $0.45 per contract).

[95] *See infra* Section VII.B.2 (discussing generally the costs and benefits of the proposal) and notes 179–183 and accompanying text (discussing the costs with respect to options exchanges that would need to amend their rules to comply with the access fee limitation as a result of proposed Rule 610(c)(2)).

[96] Delta is measured as the change in the option price divided by the change in the underlying asset price. *See* Guy Cohen, *Options Made Easy* (2d ed., Upper Saddle River: FT Prentice Hall 2005).

[97] A $0.30 per-contract access fee would be a more significant percentage of the option price as the option price decreases. For example, for an option priced at $0.01, a $0.30 per-contract access fee would be 30% of the total option price ($0.01 × 100 = $1 per contract, and $0.30 is 30% of $1). The Commission preliminarily believes, however, that a flat cap of $0.30, rather than a cap based on a percentage of the option price for low-priced options, strikes the appropriate balance, for the reasons discussed in this section. The Commission, however, requests comment on the issue. *See infra* Section V (Request for Comment).

[98] *See* Rule 612 of Regulation NMS, 17 CFR 242.612.

[99] Approximately 76% of the contract volume is in options priced at $3 or below, and approximately 48% of the contract volume is in options priced at $1 or below (these estimates are based on December 2009 volume data from OptionsMetrics).

[100] *See infra* notes 179–187 and accompanying text for a discussion of the estimated costs of the proposed fee cap on options exchanges.

[101] *See* Securities Exchange Act Release Nos. 58817 (October 20, 2008), 73 FR 63744 (October 27, 2008) (SR–CBOE–2008–105); 61133 (December 9, 2009), 74 FR 66715 (December 16, 2009) (SR–Phlx–2009–100); 61154 (December 11, 2009), 74 FR 67278 (December 18, 2009) (SR–ISE–2009–105); and 61388 (January 20, 2010), 75 FR 4431 (January 27, 2010) (SR–BX–2010–001).

such as monthly or annual fees) would not be included.

The proposed fee limitation in Rule 610(c)(2) would apply to any fee charged directly by an options exchange. It would also limit any fee charged by a market participant, such as a market maker, that displays a quotation through the exchange's facilities. The Commission, however, understands that market participants in the options markets currently do not charge access fees. Nothing in proposed Rule 610(c)(2) would preclude an options exchange from taking action to limit fees beyond what would be required under the proposed rule, and such exchange would have flexibility in establishing its respective fee schedule to comply with proposed Rule 610(c)(2).

The proposed access fee limitation in Rule 610(c)(2) would apply only to quotations that market participants are required to access to comply with the Trade-Through Rules; it would not apply to depth of book quotations. By proposing to apply the fee cap only to the best bid or offer of an options exchange, the limitation is designed to have minimal impact on competition and individual business models while furthering the objectives of the Exchange Act by preserving the fairness and usefulness of quotations, and by providing support for the proper functioning of the Trade-Through Rules, as discussed above.[102]

Further, as the Commission noted in adopting current Rule 610(c), a market participant could intend to interact only with a quotation subject to the access fee cap in Rule 610(c) but in fact execute against a quotation not subject to the cap. For example, at the time a market participant routes an order to an exchange, it could be attempting to execute only against that exchange's best bid or offer, which would be subject to the proposed fee cap. By the time the order arrives at the exchange, the incoming order may, if a better priced bid or offer has been displayed at the exchange for a size smaller than the size of the incoming order, execute partially against the new best bid or offer and partially against the quotation that was previously the exchange's best bid or offer. If the exchange were to charge a fee higher than the access fee cap to the market participant accessing the previous best bid or offer, the Commission believes that such charge could undermine the purpose of the proposed access fee cap as discussed above. Therefore, the Commission believes that to meet the requirements of proposed Rule 610(c)(2), an exchange would have to ensure that it never charges a fee in excess of the cap when a market participant tries to access only the exchange's best bid or offer.[103]

The operation of this limitation would be based on quotations as they are displayed in the consolidated quotation stream. Thus, the exchange would be responsible for ensuring that any time lag between prices in its internal systems and its quotations in the consolidated quotation system do not cause fees to be charged that would violate the limitation of proposed Rule 610(c)(2). Compliance with this requirement obviously would not be a problem for exchanges that do not charge any fees in excess of the proposed cap. If an exchange were to choose to charge higher fees for access to its depth of book quotations,[104] the Commission does not believe the exchange could comply with the proposed Rule 610(c)(2) unless it provided a functionality that enables market participants to assure that they will never inadvertently be charged a fee in excess of the cap. For example, such an exchange could provide a "top-of-book only" or "limited-fee only" order functionality. By using this functionality, market participants themselves could assure that they were never required to pay a fee in excess of the levels proposed in Rule 610(c)(2).[105] Further, for similar reasons, the proposed access fee limitation in Rule 610(c)(2) would apply to an exchange's non-displayed quotations in listed options that are priced better than the exchange's displayed best bid or offer. Specifically, if an exchange had an order type that allowed an order to be entered at a price that is not displayed but is available for execution, the proposed fee limitation would apply to an execution against that non-displayed price.[106]

C. Payment for Order Flow

In a traditional payment for order flow arrangement in the options market, a specialist or market maker offers cash and non-cash inducements to brokers that direct orders to the specialist or market maker. The specialist or market maker is willing to pay firms for this order flow because it knows that it will be able to trade with a portion of such orders due to specialist and market maker guarantees provided by the exchanges.[107] In addition, some exchanges have adopted fees on market makers to facilitate their members' payment for order flow.[108] Typically, the exchange charges each market maker a fee for trading with customer orders on the exchange. The exchange then pools the proceeds from such fees and allows specialists and/or market makers to use such funds to pay for order flow.[109]

Several commenters argue that, if the Commission were to limit "Take" fees, it also should limit fees associated with payment for order flow arrangements.[110]

[102] *See* NMS Adopting Release, *supra* note 4, at 37546.

[103] This is consistent with the approach in Regulation NMS. *Id.*

[104] The Commission is not aware of any options exchange that charges differential fees for accessing depth-of-book quotations, but requests comment on the issue.

[105] The existing access fee cap for NMS stocks operates in this same manner. *See id.*

[106] *See, e.g.,* Chapter VI, Sections 6 and 7 of the NOM Rules governing NOM's price improving order type. "Price Improving Orders" are defined under the NOM Rules as orders to buy or sell an option at a specified price at an increment smaller than the minimum price variation in the security. Price Improving Orders may be entered in increments as small as one cent, and those Price Improving Orders that are available for display must be displayed at the minimum price variation in that security and rounded up for sell orders and rounded down for buy orders. *See* Chapter VI, Section 1(e)(6) of the NOM Rules (defining Price Improving Orders).

[107] *See, e.g.,* CBOE Rule 8.13 and ISE Rule 713.

[108] *See, e.g.,* Securities Exchange Release Nos. 48053 (June 17, 2003), 68 FR 37880 (June 25, 2003) (SR–Amex–2003–50) (immediately effective proposed rule change to reinstate marketing fee to raise revenue for Amex specialists to compete for order flow); 47948 (May 30, 2003), 68 FR 33749 (June 5, 2003) (SR–CBOE–2003–19) (immediately effective proposed rule change to reinstate marketing fee to compete for order flow); 47090 (December 23, 2002), 68 FR 141 (January 2, 2003) (SR–Phlx–2002–75) (immediately effective proposed rule change to reinstate marketing fee to compete for order flow); 43833 (January 10, 2001), 66 FR 7822 (January 25, 2001) (SR–ISE–00–10) (order approving ISE's payment for order flow program); 43290 (September 13, 2000), 65 FR 57213 (September 21, 2000) (SR–PCX–00–30) (immediately effective proposed rule change to adopt a payment for order flow fee); 43228 (August 30, 2000), 65 FR 54330 (September 7, 2000) (SR–Amex–00–38) (immediately effective proposed rule change to establish new marketing fee to raise revenue for Amex specialists to compete for order flow); 43177 (August 18, 2000), 65 FR 51889 (August 25, 2000) (SR–Phlx–00–77) (immediately effective proposed rule change to adopt a payment for order flow fee); and 43112 (August 3, 2000), 65 FR 49040 (August 10, 2000) (SR–CBOE–00–28) (immediately effective proposed rule change to establish new CBOE marketing fee to raise revenue that could be used by CBOE market makers to pay for order flow).

[109] For example, NYSE Amex LLC ("NYSE Amex") imposes a $0.65 per-contract marketing fee for non-Minimum Quoting Increment Pilot Program classes and a $0.25 per-contract marketing fee for Minimum Quoting Increment Pilot Program classes where a market maker trades against an incoming electronic customer order. *See* NYSE Amex Options Fee Schedule (available at *http://www.nyse.com/pdfs/NYSE_Amex_Options_Fee_Schedule01.04.10.pdf*) (current as of January 4, 2010).

[110] *See* BOX Letter, *supra* note 37, at 2 (stating its belief that, if the Commission does decide to enact fee caps, a cap on Take fees is acceptable only to the extent that other options exchanges are willing to accept a comparable limit on payments and fees

Continued

This view is premised on the notion set forth by several commenters that payment for order flow fees affect quoted prices, and thus executions received by investors, because market makers that have to pay for order flow will reflect that cost in their quoted prices.[111] In this regard, one commenter petitioned the Commission to impose a cap at the same level on private payment for order flow arrangements between market makers and agency brokerage firms as any cap it imposes on "Take" fees.[112] Another commenter argues that fees relating to "accessing" quotations can be characterized broadly to include exchange fees used to fund members' payment for order flow.[113]

The Commission agrees with commenters that payment for order flow fees, among other costs, affect quoted prices. However, the Commission is not proposing to specifically limit payment for order flow, nor the exchange fees imposed on market makers to fund members' payment for order flow. Instead, the Commission is proposing to limit the amount of fees that an exchange can impose, or permit to be imposed, for access to the best bid and offer of the exchange. The Commission preliminarily does not believe that an exchange payment for order flow fee on members is an access fee, *i.e.,* it is not a fee imposed for executing against an exchange's quotation. The basis for the proposal, as discussed at length above,[114] is to (1) provide for fair and efficient access to displayed quotations to support the integrity of the price protection requirement contained in the Trade-Through Rules, and (2) further the objective that quotations be fair and useful by limiting the extent to which the all-in price can vary from the displayed price.

The Commission preliminarily believes these objectives can be achieved without limiting payment for order flow fees. Payment for order flow is when a market maker offers cash and non-cash inducements to brokers that direct orders to the market maker. In addition, some exchanges impose a fee on market makers to facilitate their members' payment for order flow.[115] Payment for order flow fees are not fees imposed by an exchange on incoming orders for executing against an exchange's quotations. Therefore, the Commission preliminarily does not believe that payment for order flow fees directly impact the ability of a market participant to access an exchange's best priced displayed quotations, and therefore does not believe that limiting payment for order flow fees is necessary to achieve the objectives of the proposed fee cap—to provide for fair and efficient access to displayed quotations and that displayed quotations be fair and useful.

However, if a market maker is charged a payment for order flow fee by an exchange when the market maker is accessing the best bid or offer of the exchange, then the proposed fee limitation would apply to that fee because it would be a fee for the execution of an order against the best bid or offer of the exchange. A payment for order flow fee would be a fee for accessing an exchange's best bid or offer if, for example, a market maker's quote traded against a resting customer limit order that is the best bid or offer of the exchange. Similarly, a payment for order flow fee would be a fee for accessing an exchange's best bid or offer if a market maker sent an order in a class to which it is not appointed as a market maker, and that order trades against a customer order resting on the exchange's limit order book that is the best bid or offer of the exchange. In sum, if the rules of the exchange provide that the market maker would pay a payment for order flow fee for executing against the resting customer order that is the best bid or best offer of the exchange, that fee would be covered by proposed Rule 610(c)(2).

On several occasions, the Commission has recognized that the anticipation of payment for order flow raises a potential conflict of interest for brokers handling customer orders, and that reliance by market centers on the strategy of simply paying money to attract orders may present a threat to aggressive quotation competition.[116] At the same time, the Commission has stated that payment for order flow is not necessarily inconsistent with a broker's duty of best execution, so long as appropriate measures are taken to ensure that that duty is, in fact, met.[117] The Commission further acknowledges the broader concern that payment for order flow may result in less aggressive competition for order flow on the basis of price,[118] such as through displaying aggressively-priced quotations or offering opportunities for price improvement. However, the Commission has stated that singling out and banning only one particular form of such payment—for example, payment made possible by an exchange through the collection of fees from its market makers—would scarcely address the issue on the larger scale.[119]

Further, as noted above, the Commission believes that market forces and the dynamics of competition should determine exchange fees, to the extent practicable.[120] Payment for order flow fees generally are charged by exchanges to market makers when they execute against a customer order. If a market maker does not want to pay this fee, the market maker is free to give up its appointment as a market maker on that exchange and become a liquidity provider on another exchange with a more attractive fee structure. For instance, an exchange may set a fee to collect funds for members' payment for order flow at such a level that a market maker may determine it can no longer effectively compete for order flow based on its quotations, which must incorporate the costs of all fees.[121] The market maker may then make the determination to become a liquidity provider on another exchange where it is able to compete more effectively based on the price of its quotations. Similarly, an exchange may determine to charge any market participant a fee for providing liquidity on its exchange.[122] If a market participant did not want to pay this fee, it could choose to send its non-marketable limit order to another options exchange with a more

associated with exchange payment for order flow) and Wolverine Letter, *supra* note 37, at 7 (stating that any cap on make-take fees should be made in conjunction with a commensurate cap on payment for order flow fees).

[111] *See* BOX Letter, *supra* note 37, at 4; GETCO Letter, *supra* note 37, at 3–6; IB Letter, *supra* note 37, at 2–3 and 6–7; and Wolverine Letter, *supra* note 37, at 4.

[112] *See* IB Letter, *supra* note 37, at 1 and 6.

[113] *See* Wolverine Letter, *supra* note 37, at 3.

[114] *See supra* notes 58–100 and accompanying text.

[115] *See supra* notes 107–109 and accompanying text.

[116] *See, e.g.,* Options Concept Release, *supra* note 21, at 6128–6130.

[117] *See* Securities Exchange Act Release No. 43833 (January 10, 2001), 66 FR 7822 (January 25, 2001) (SR–ISE–00–10) (citing to Securities Exchange Act Release No. 42450 (February 23, 2000), 65 FR 10577 (February 28, 2000)); *see also* Options Concept Release, *supra* note 21, at 6128–6129.

[118] *See* Securities Exchange Act Release No. 43833, *supra* note 117, at 7825.

[119] *Id.*

[120] *See supra* note 58.

[121] This would assume that the amount of the payment for order flow fee impacts the price at which the market maker is willing to quote.

[122] *See, e.g.,* BOX Fee Schedule, Section 7 (available at *http://www.bostonoptions.com/pdf/BOX_Fee_Schedule.pdf*) (current as of January 2010) (imposing a $0.55 fee for adding liquidity in Non-Penny Classes, a $0.15 fee for adding liquidity in Penny Pilot Classes except SPY, QQQQ, and IWM, and a $0.05 fee for adding liquidity in SPY, QQQQ, and IWM). In its filing imposing this fee, BOX stated that the changes proposed are in response to various "Payment for Order Flow" programs currently in operation on other options exchanges. *See* Securities Exchange Act Release No. 60934 (November 4, 2009), 74 FR 58358 (November 12, 2009).

attractive fee structure. The Commission therefore preliminarily believes that competition among the various options exchanges, and the different market models, will act to restrict payment for order flow and other fees for providing liquidity.[123]

IV. Technical Amendments to Rule 610

The Commission is proposing to amend Rule 610(c) to reflect that Nasdaq is now registered as a national securities exchange under Section 6(a) of the Exchange Act.[124] The current rule's prohibition on a trading center imposing, or permitting to be imposed, fees in excess of the stated limits applies to the execution of an order against a protected quotation of the trading center or against any other quotation of the trading center that is "the best bid or best offer of a national securities exchange, the best bid or best offer of The Nasdaq Stock Market, Inc., or the best bid or best offer of a national securities association other than the best bid or best offer of The Nasdaq Stock Market, Inc. in an NMS stock." Given Nasdaq's current status as a registered national securities exchange, there no longer is a need to separately reference Nasdaq's best bid or best offer. Therefore, the Commission is proposing to amend Rule 610(c)(1) to simplify the relevant language to refer only to any other quotation of the trading center that is the best bid or best offer of a national securities exchange or the best bid or best offer of a national securities association in an NMS stock.[125]

The Commission also is proposing to make technical changes to Rule 610(c) to reflect the addition of proposed Rule 610(c)(2) that would apply to listed options.

[123] The Commission also notes that the exchanges generally lowered the level of payment for order flow fees charged to their market makers in classes included in the Minimum Quoting Increment Pilot Program. *See* Securities Exchange Act Release Nos. Securities Exchange Act Release Nos. 55328 (February 21, 2007), 72 FR 9050 (February 28, 2007) (SR–Amex–2007–16); 55265 (February 9, 2007), 72 FR 7697 (February 16, 2007) (SR–CBOE–2007–11); 55271 (February 12, 2007), 72 FR 7699 (February 16, 2007) (SR–ISE–2007–08); 55223 (February 1, 2007) 72 FR 6306 (February 9, 2007) (SR-NYSEArca–2007–07); and 55290 (February 13, 2007), 72 FR 8051 (February 22, 2007) (SR–Phlx–2007–05). As noted above, currently approximately 69.5 percent of trading volume is in classes included in the Minimum Quoting Increment Pilot Program where trading interest can be represented in the quote in one-cent increments, and by August 2, 2010, 363 classes will be included in the Minimum Quoting Increment Pilot Program, representing approximately 88.1 percent of trading volume during February 2010. *See supra* note 29 and accompanying text.

[124] *See* 15 U.S.C. 78f(a); *see also* Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006).

[125] *See* proposed Rule 610(c)(1).

V. Request for Comments

The Commission requests the views of commenters on all aspects of this proposal, including whether the proposal is consistent with the provisions of the Exchange Act. In particular, the Commission requests comment on the following:

1. Rule 610(a) currently prohibits the imposition of unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member of the exchange to quotations in NMS stocks. The Commission requests comment on its proposal to extend this prohibition to include access to quotations of listed options. The Commission further requests comment on whether the Commission's rules also should prohibit unfairly discriminatory terms for other services offered by exchanges. For example, should the Commission rule be expanded to cover exchange transaction fees generally, even those transaction fees that are not based on accessing the exchange's quotations?

2. Rule 610(a) as proposed to be amended would prohibit an exchange from charging higher "Take" fees in certain options classes to non-directed customers than to directed customers. Do commenters agree that such a fee differential should be prohibited by the proposed amendments to Rule 610(a)?

3. As discussed above, the Commission is proposing to limit fees charged for accessing the best bid and offer in a listed option, as proposed in Rule 610(c)(2), to support fair and efficient access to an exchange's quotations, and to provide greater transparency in the quoted price. To what extent is this action necessary to achieve these objectives? To what extent do competitive forces in the options markets currently act, or will continue to act, to keep fees such as access fees at a level that does not impede fair and efficient access to an exchange's quotations, or impede the transparency of the quoted price? Does the existence of flash functionality at some of the exchanges that trade listed options have an impact on the level at which options exchanges set access fees?[126]

4. The markets for trading NMS stocks are similar in certain ways to the markets for trading listed options, and in other ways are different. The Commission requests comment on whether, and how, those similarities and differences should impact a decision to apply an access fee cap, as proposed, in the options markets. For example, both NMS stocks and listed options can be traded on multiple markets, and broker-dealers that trade NMS stock and listed options have a duty of best execution with respect to each. Likewise, both markets have prohibitions on trading-through. How, if at all, do these similarities support, or not, the proposed fee cap for accessing an options exchange's best bid and offer?

Unlike NMS stocks, listed options are only traded on exchanges, and not in the over-the-counter ("OTC") market. It can be argued that one result of the lack of OTC trading in listed options is that more "good" order flow (that is, order flow relatively uninformed about future prices) reaches the options exchanges than the exchanges that trade NMS stocks.[127] It can be further argued 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.[128] In addition, it is argued that investors in listed options depend upon the liquidity supplied by professional liquidity providers to a greater extent than in the market for NMS stocks.[129] Further, some market participants state that liquidity providers price options differently than liquidity providers price NMS stocks, pursuant to pricing models or algorithms rather than based on the inherent value of the issuer.[130] Do commenters agree with these statements? How, if at all, do these differences mitigate for or against applying the proposed fee cap for accessing an options exchange's best bid and offer? Do these differences impact the incentives for liquidity providers to quote aggressively, or the competitiveness of an options exchange's fees, differently than a

[126] The Commission separately has proposed changes to Rule 602 of Regulation NMS that, if adopted, would affect flash functionality in the listed options markets, raising concerns about access to order information and incentives for market participants to display their trading interest publicly. *See* Flash Order Proposal, *supra* note 19, and *supra* notes 72–75 and accompanying text.

[127] *See* ISE Flash Letter, *supra* note 73, Appendix B at 2.

[128] *See* Letter from Larry Harris, Professor of Finance and Business Economics, USC Marshall School of Business, dated December 4, 2009 ("Harris Letter") at 4. 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.

[129] *See* CBOE Flash Letter, *supra* note 73, at 1 and 10; ISE Flash Letter, *supra* note 73, at 9. *See also* 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.

[130] *See* ISE Flash Letter, *supra* note 73, at 7–8.

market participant or market trading NMS stocks?

5. The Commission requests comment on the different sources of revenue available to options exchanges, and any differences between those sources available to options exchanges and exchanges that trade NMS stocks. For example, exchanges that have in place rules for listing NMS stocks have the ability to charge listing fees to issuers for listing on their market. Does the amount of revenue received from market data differ significantly for options exchanges versus exchanges that trade NMS stocks? How, if at all, should any differences in sources of revenue for options exchanges versus exchanges that trade NMS stocks mitigate for or against applying the proposed fee cap for accessing an options exchange's best bid and offer? How, if at all, should any differences in sources of revenue for options exchanges versus exchanges that trade NMS stocks impact a determination as to the level of an access fee cap to be imposed?

6. If commenters do not believe that the Commission should limit fees charged for accessing the best bid and offer in a listed option, as proposed in Rule 610(c)(2), do commenters believe that the Commission should take any action with respect to fees charged, or permitted to be charged, by an options exchange for executing against the exchange's best bid or offer in a listed option? If not, please explain why not. If so, please explain why, and what alternative action the Commission should take. For example, would commenters support action by the Commission to cap all fees for executing an options order, including access fees, routing fees, and any other per contract fee, at the minimum pricing variation for the option? Would this alternative achieve the objectives of the proposed fee cap, as discussed above in Section III? Would this alternative approach provide more or less flexibility to exchanges than an access fee cap as proposed in Rule 610(c)(2)?

7. The Commission is proposing a flat fee cap of $0.30 per contract. As discussed above, the Commission's proposal is based on several factors. First, the $0.30 per-contract level is consistent with the maximum fee limit for NMS stocks under Rule 610(c). Experience of the markets trading NMS stocks in recent years suggests that a fee cap of $0.30 per 100 shares did not prevent markets using a Make or Take fee model from competing effectively in a market where some participants engage in payment for order flow.[131] In addition, this access fee cap level would help ensure that the "all-in" fee would be below the $1 minimum quoting increment. Further, the Commission preliminarily believes that setting the proposed fee cap at $0.30 per contract would allow options exchanges flexibility to generate revenues from access fees while still providing the exchange the ability to continue to charge other fees, such as "licensing" fees charged by exchanges for executions in certain index options or routing fees, without exceeding the $1 minimum increment. The Commission requests comment on this analysis. If commenters agree with this approach and threshold, please explain why; if commenters do not agree, please explain why not.

8. If a commenter believes that a fee cap for accessing the best priced quotation in listed options is necessary and appropriate, the Commission requests comment as to what level such a cap should be set, and what considerations should be part of any analysis as to the level of a fee cap. One commenter states that while 30% of the minimum quoting increment is a reasonable access fee cap for the equity markets, which allow internalization as a defense to excessive access fees, a lower cap is needed in the options markets because internalization is not permitted, and suggests a cap of $0.20 per contract.[132] Other commenters argue that any fee cap should not be lower than $0.99 per contract (for options quoted in one-cent increments) because a customer is still better off paying a $0.99 per contract fee to execute against a price that is better by $1.00 per contract.[133] The Commission requests commenters' views on each of these alternative levels, and the reasoning supporting them.

9. One of the bases for the proposed access fee cap is to support the requirements of the Trade-Through Rules and the duty of best execution. It could be argued that because investors will not be worse off accessing a price that is better by $1 per contract as long as the fee to access that quotation is not more than $0.99 per contract,[134] any fee cap should not be lower than $0.99 per contract to support the operation of the Trade-Through Rules. Do commenters agree with this view? Should the fact that there is no guarantee that an order sent to another exchange to access a better displayed price will actually obtain an execution on the away exchange impact the level at which an access fee is capped? Should there be the possibility for more than a one-cent per contract advantage (which is what would result with an access fee of $0.99 per contract) to require market participants to attempt to access quotations in listed options on other exchanges that are better priced by $1 per contract? What percent of the time do orders sent to another exchange to access a better displayed price actually obtain an execution on the away exchange? What other considerations, if any, should the Commission take into account when determining the level of any fee cap imposed for access to an exchange's best bid or offer in a listed option?

10. As discussed above in Question 4, the markets for trading NMS stocks are similar in certain ways to the markets for trading listed options, and in other ways are different. The Commission requests comment on whether, and how, those similarities and differences should impact the *level* at which an access fee cap should be set for access to an options exchange's best bid and offer. Should any limit on access fees that can be imposed by the options exchanges be different than or the same as the existing limit on access fees in the market for NMS stocks? If different, please explain whether an access fee limit in the options exchanges should be higher or lower than the limit for NMS stocks, and the basis for the difference. If the same, please explain why, with specificity.

11. As discussed above, the Commission has proposed a flat access fee cap of $0.30 per contract, and not proposed a percentage fee limit for low-priced options, similar to the 0.3 percent of the price per share limit for NMS stocks priced under $1.[135] The Commission preliminarily believes that differences in the markets for NMS stocks and listed options merit this distinction. Specifically, when an NMS stock is trading at a very low price, the access fee can become significant as a percentage of the total economic exposure. This result is less likely for listed options, given the leverage implicit in an option contract.[136] In

[131] *See infra* note 172 and accompanying text.

[132] *See* Citadel Petition, *supra* note 34, at 10.

[133] *See* BOX Letter, *supra* note 37, at 5 (stating in part that if the Commission were to impose a fee limit that it should be $0.01 per contract less than the standard trading increment of the class); and IB Letter, *supra* note 37, at 4–5 (opposing any fee cap less than $0.99 per contract for a contract quoted in pennies).

[134] *Id.*

[135] *See supra* notes 96–100 and accompanying text.

[136] For example, if an NMS stock is trading for $0.01 per share, so that an order for 100 shares represents $1 worth of stock, an access fee of $0.30 for 100 shares would represent thirty percent of the total economic position. On the other hand, an NMS stock priced at $10 per share could have a

addition, the restriction on subpenny quoting in NMS stocks does not apply to stocks priced below $1. Thus, for certain low-priced NMS stocks, an access fee of $0.003 per share could be larger than the minimum quoting increment, making it possible for an order to be routed to an exchange quoting a better price but ending up with an inferior all-in price after the access fee. For NMS stocks, the percentage fee cap for stocks priced below $1 helps to mitigate this concern. Because listed options are not currently quoted in subpenny increments, these concerns are not present, and, therefore, the Commission preliminarily believes it is unnecessary to establish a cap based on a percentage of the options' price for low-priced options.[137]

The Commission requests comment on its analysis, and whether the proposed access fee limit should have a percentage fee limit for low-priced options, similar to the 0.3 percent of the price per share for NMS stocks priced under $1, and on its reasoning for not proposing such a percent-based limit for low-priced options. If commenters believe that the proposed access fee cap should be different for low-priced options, please explain with specificity why, and what the breakpoint should be, and why.

12. As discussed above, one of the bases for the proposed fee cap is to ensure the fairness and usefulness of displayed quotations, and to enhance transparency of displayed quotations. The Commission requests comment as to whether there is a need to promote transparency of the displayed quotations in listed options beyond the status quo.

13. If commenters believe that, to support the transparency of displayed quotations, there should be a limit as to how far away from the quoted price the amount that the investor would pay (for a buy) or receive (for a sell) inclusive of access fees should be, what factors should go into determining the allowable deviation? For example, should access fees be limited to one increment less than the minimum quoting increment (for example, $0.99 per contract in an option that has a one-cent minimum increment), such that the investor would always get a better execution price net of access fees when the quoted price is better by one minimum quoting increment? Should the access fees be limited to less than half of the minimum quoting increment (for example, $0.50 per contract in an option that has a one-cent minimum increment), so that the net price to investors inclusive of access fees is closer to the displayed price than the next worse price? Should the allowable access fees be some other amount?

14. The Commission requests comment on whether there are alternative methods other than the proposed access fee cap to achieve the objective of greater transparency in displayed quotations of listed options.

15. The Commission requests comment on the types of fees that should be covered by an access fee limitation. For example, the Commission believes that proposed Rule 610(c)(2) would apply to fees charged for the execution of options on certain indexes (so-called "licensing fees," "royalty fees," or "index surcharge fees"). Please state why it would be appropriate or not appropriate to apply the proposed fee limitation to licensing fees. What would be the impact on these fees if the proposed fee limitation did apply? What would be the impact on market quality if the proposed fee limitation applied to licensing fees?

16. The Commission requests comment on its preliminary view of the applicability of the proposal to an ORF.[138] The Commission also requests comment on any potential impact of the proposal on an ORF.

17. As proposed, the fee limitation in Rule 610(c)(2) would apply to fees charged for executions of orders in all listed options, including those that are listed and traded only on one options exchange ("non-multiply listed options"). Do commenters agree that Rule 610(c)(2) should apply to trades in such options? Or should any fee cap apply only to multiply listed options? Or should the proposed fee limitation in Rule 610(c)(2) be set at a different level for non-multiply listed options? If commenters believe the proposed fee limitation in Rule 610(c)(2) should not apply to fees charged for executions of orders in non-multiply listed options, please explain why and how "non-multiply listed options" should be defined.

18. As proposed, the fee limitation in Rule 610(c)(2) would apply to fees charged for the execution of orders in FLEX options and to the execution of complex orders.[139] Do commenters agree that Rule 610(c)(2) should apply to such transactions? If so, should the proposed fee limitation in Rule 610(c)(2) be set at a different level for orders in FLEX options or complex orders? If commenters believe the proposed fee limitation in Rule 610(c)(2) should not apply to fees charged for the execution of orders in FLEX options or to the execution of complex orders, please explain why.

19. What would be the impact of the proposed access fee cap in Rule 610(c) on market quality? In particular, the Commission encourages submission of any data that quantifies potential benefits or harm.

20. Do commenters believe that limiting access fees as proposed in Rule 610(c) would have a disparate effect on one type of market model over another? If not, why not? If so, how? And if so, how would the disparate effect impact the ability of exchanges with different market models to compete with each other? The Commission further requests comment as to whether, and if so how, the quoting, order routing or other behavior of market participants would change if the proposed fee cap were in place.

For example, as discussed above, several commenters express concern with limiting Take fees without also limiting payment for order flow fees.[140] They argue that market participants on Make or Take exchange quote more aggressively because of the Make rebates paid for providing liquidity that are funded by the Take fees charged to liquidity takers.[141] Exchanges with Make or Take fee models thus provide direct competition based on aggressive quoting to exchanges with payment for

short-term out-of-the-money option priced at $0.01. If the Delta of this option is 0.05, then one option contract would cost $1 but would give the investor exposure equivalent to an investment of $50 of the stock. An access fee of $0.30 per contract for the option would only represent six-tenths of one percent of the economic position.

[137] Commission staff also estimates that imposing a flat $0.30 per-contract cap, and not including a percentage fee cap for low-priced options similar to the existing fee cap of 0.3 percent of the quotation price per share for NMS stocks, would result in less potential revenue loss for options exchanges from the impact of the proposed fee cap. *See supra* notes 99–100 and accompanying text.

[138] *See supra* note 101 and accompanying text.

[139] A complex order is any order involving the simultaneous purchase and/or sale of two or more different options series in the same underlying security, for the same account, in a ratio that is equal to or greater than one-to-three (.333) and less than or equal to three-to-one (3.00) and for the purpose of executing a particular investment strategy. *See, e.g.,* ISE Rule 722. *See also, e.g.,* CBOE Rule 6.53C (describing a complex order generally as any of the following orders for the same account, including Spread Orders, Straddle Orders, Strangle Orders, Combination Orders, Ratio Orders, Butterfly Spread Orders, Box/Roll Spread Orders, Collar Orders and Risk Reversals, Conversions and Reversals, and Stock-Option Orders). A flex option is a customized option contract that provides the ability to customize key contract terms, like exercise price, exercise styles and expiration dates. *See, e.g., http://www.cboe.com/Institutional/FLEX.aspx;* CBOE Rule 24A.4.

[140] *See supra* note 82 and accompanying text.

[141] *See* BOX Letter, *supra* note 37, at 3; IB Letter, *supra* note 37, at 2–3. *See also* ISE Flash Letter, *supra* note 73, at 8; and Harris Letter, *supra* note 128, at 2.

order flow models because a market maker on a payment for order flow exchange must match the better prices on the Make or Take exchange, or route to the Make or Take exchange and pay the Take fee.[142] Limiting the amount of a Take fee a Make or Take exchange can charge will directly impact the amount of a Make rebate the exchange can pay to liquidity providers, which in turn will impact a liquidity provider's incentive to quote aggressively, thus limiting the Make or Take exchange's ability to compete with an exchange with a payment for order flow fee model through aggressive quoting.[143]

The Commission requests comment on whether commenters agree with this view. Do commenters agree that liquidity providers on Make or Take exchanges quote more aggressively than liquidity providers on 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 Make or Take exchanges are willing to quote aggressively? For example, does the absence of order flow captured by payments to routing brokers or the absence of guaranteed allocations for liquidity providers also contribute significantly to aggressive quoting by liquidity providers on Make or Take exchanges?

Do commenters believe that limiting Take fees, which are a type of access fee, would result in reduced Make rebates paid for supplying liquidity? If so, what are commenters views as to how much Make rebates would be reduced in reaction to reduced Take fees? What would be the impact, if any, of reduced Make rebates on market participant incentives to aggressively quote on exchanges employing a Make or Take fee model? To the extent that commenters believe that limiting Take fees would result in reduced Make rebates paid for supplying liquidity, and that reduced Make rebates would adversely impact market participant incentives to aggressively quote on exchanges employing a Make or Take fee model, what impact would this have on those market participants supplying liquidity? Or on investors taking liquidity?

The Commission requests comment as to the impact of the proposed fee cap on the ability of an exchange with a Make or Take fee model to compete with exchanges with a payment for order flow model. For example, to the extent that commenters believe that limiting Take fees would result in reduced Make rebates paid for supplying liquidity, and that reduced Make rebates would adversely impact market participant incentives to aggressively quote on exchanges employing a Make or Take fee model, do commenters believe that a $0.30 per contract access fee cap, as proposed, would allow Make or Take exchanges to pay a large enough rebate to continue to incent market participants to quote aggressively, and thus compete more aggressively on price with payment for order flow exchanges?

21. 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 extent do liquidity providers on payment for order flow options exchanges quote aggressively rather than merely matching the NBBO set elsewhere? Would applying an access fee cap, as proposed, lead market participants on one or both types of options exchange to quote more aggressively and thereby narrow NBBO spreads for listed options? Or would applying an access fee cap lead market participants on one or both types of options exchanges to quote less aggressively? Does your answer change depending on whether the Commission adopts a ban on flash functionality in the options markets?[144]

22. As noted above, the Commission recognizes that even though it is not proposing to prohibit an exchange from employing any particular market model, the proposed fee limitation may impact different market models in different ways. An exchange with either a Make or Take fee model that charges a Take fee in excess of the proposed fee cap, or an exchange with a Broker Payment fee model that charges a transaction fee in excess of the proposed fee cap, would take in less revenue per contract from a reduced Take or transaction fee, as applicable. These reduced fees for accessing an exchange's best bid or offer, standing alone, might have an impact on the manner in which broker-dealers and other market participants, including the exchanges, route order flow. The exchange with the Make or Take fee model, however, might choose to recoup some of that revenue by reducing its Make rebate, which may have an impact on the quoting behavior of market participants that provide liquidity on that exchange. An exchange with a Broker Payment model might choose to recoup some of the revenue by amending other fees charged to its members, which might impact the order routing or other behavior of those members (and the members' customers), depending upon the type of fee change.

The Commission requests comment on how the exchanges might reallocate their sources of revenue, if at all, in response to the access fee limit in proposed Rule 610(c)(2). What changes, if any, to fees other than access fees imposed by, or rebates paid by, exchanges would the options exchanges make in response to being required to limit access fees as proposed? Would any potential disparate impact from these fees changes across exchange fee models lead to harm to investors? If so, please explain. How, if at all, would potential changes to fees other than access fees imposed on members by exchanges impact the behavior of particular categories of market participants, such as retail investors, market makers, and broker-dealers?

23. As noted above in Question 20, several commenters express concern with limiting Take fees without also limiting payment for order flow fees. They argue that limiting the amount of a Take fee a Make or Take exchange can charge will directly impact the amount of a Make rebate the exchange can pay to liquidity providers, which in turn will impact a liquidity provider's incentive to quote aggressively, thus limiting the Make or Take exchange's ability to compete with an exchange with a payment for order flow fee model through aggressive quoting.[145] The Commission notes that the percent of overall contract volume for trading in equity options for the month of February 2010 for each exchange that primarily employs a Make or Take fee model ranges from 2.83 percent to 15.36 percent, and that the aggregate market share of these exchanges was 18.19 percent.[146] Exchanges that primarily employ a Broker Payment Model had an aggregate market share of overall contract volume for trading in equity options for the month of February 2010 of 81.81 percent.[147] The Commission requests comment as to the reasons why

[142] *See* IB Letter, *supra* note 37, at 3; GETCO Letter, *supra* note 37, at 6–7.

[143] *See id.*

[144] *See supra* notes 19 and 72–75.

[145] *See supra* notes 140–143 and accompanying text.

[146] *See http://www.theocc.com/webapps/exchange-volume.* The data is for the month of February 2010 and includes market share for NOM and NYSE Arca, but does not include BATS, which began trading options on February 26, 2010.

[147] This data also is from OCC's public website and is for the month of February 2010. *See http://www.theocc.com/webapps/exchange-volume.* This data covers percent volume for BOX, CBOE, ISE, NYSE Amex, and Nasdaq OMX Phlx.

commenters believe that the Make or Take fee model has not resulted in greater market share to date, given the arguments that the payment of a Make rebate acts as a direct incentive to quote more aggressively. For instance, how does the existence of flash functionality on other exchanges impact the ability of Make or Take exchanges to compete on quoted price?

24. The proposed fee limitation in Rule 610(c)(2) would prohibit an exchange from imposing, or permitting to be imposed by market participants, any fee or fees that exceed or accumulate to more than the proposed limit. The Commission requests comment on whether it is necessary in the listed options exchanges to include a prohibition, as proposed, on an exchange permitting other market participants to impose fees that exceed the limit. The Commission does not believe that market makers in listed options currently impose fees for the execution of orders against their quotes on an exchange, but requests comment on whether they do. Do commenters think it likely that market makers would in the future impose such fees?

25. In this proposal, the Commission has not proposed to limit payment for order flow fees. As stated above, an exchange payment for order flow fee on members is not an access fee, *i.e.,* it is not a fee imposed for executing against an exchange's quotation.[148] The Commission therefore preliminarily does not believe that it is necessary or appropriate to prohibit payment for order flow fees to achieve its stated objectives in proposing to cap access fees—to ensure fair and efficient access to displayed quotation and to enhance transparency of quoted prices. Several commenters, however, argue that payment for order flow fees also impact the displayed (quoted) prices, and thus the prices received by investors when their orders are executed, because market makers that are charged the payment for order flow fees adjust the price at which they are willing to quote to take into account the amount of the payment for order flow fee. In this regard, one commenter petitioned the Commission to impose a cap at the same level on private payment for order flow arrangements between market makers and agency brokerage firms as any cap it imposes on "Take" fees.[149] Another commenter argues that fees relating to "accessing" quotations can be characterized broadly to include exchange fees used to fund members' payment for order flow.[150] Do commenters agree with these statements? If so, do commenters believe that the Commission should limit payment for order flow fees as an "access fee"? The Commission further requests comment on its preliminary determination not to limit payment for order flow fees, and the basis for that determination.

26. As noted above, the Commission has previously acknowledged a concern that payment for order flow may result in less aggressive competition for order flow on the basis of price.[151] To what extent, if any, does payment for order flow in the options markets affect a specialist's or market maker's incentive to quote aggressively? To what extent does payment for order flow in the options markets affect the opportunities for non-professional customers to receive better prices than displayed quotations in price improvement mechanisms? If commenters believe that payment for order flow diminishes a specialist's or market maker's incentives to quote aggressively, what impact, if any, do commenters believe that diminished incentive has on the quality of displayed quotations? How, if at all, would limiting or prohibiting payment for order flow fees impact broker-dealer's ability to obtain best execution of their customer's orders?

27. On several occasions, the Commission has recognized that the anticipation of payment for order flow raises a potential conflict of interest for brokers handling customer orders, and that reliance by market centers on the strategy of simply paying money to attract orders may present a threat to aggressive quotation competition. At the same time, the Commission has stated that payment for order flow is not necessarily inconsistent with a broker's duty of best execution, so long as appropriate measures are taken to ensure that that duty is, in fact, met.[152] Do customer orders that are routed pursuant to payment for order flow arrangements receive less favorable executions than orders not subject to such arrangements?

28. Some may argue that specialists and market makers in the options markets establish the prices and sizes of their quotations based in part on the assumption that their counterparties will be other professional traders, which involves more risk than trading with uninformed non-professional traders.[153] The desirability of trading with uninformed order flow due to the lower risks of trading with non-professionals should translate into those orders, on average, receiving better prices than the specialist's or market maker's quotation.[154] Under this argument, specialists and market makers may use payment for order flow as an indirect way to provide a better execution to uninformed or non-professional orders. Do commenters agree with these statements?

29. The Commission requests comment on what, if any, impact the proposed limitation on access fees may have on payment for order flow fees.

30. The Commission requests comment on whether the proposed access fee limitation should apply only to the best bid and offer of each exchange, or whether the limitation also should apply to "depth of book" quotations.

31. Some commenters stated that Make or Take pricing leads to more locked and crossed markets,[155] while others dispute that.[156] The Commission requests commenters' views on this issue. Please provide data that support your view. Could any increase in the incidence of locked and crossed markets be caused or influenced by other factors, such as more efficient and faster quotation updating and trading, or the expansion of the Minimum Quoting Increment Pilot Program? How, if at all, does the recently implemented Plan [157] help alleviate the frequency of locked and crossed markets? How, if at all, would the proposed limitation on access fees affect the frequency of locked/crossed markets?

32. The Commission requests comment on what the impact of imposing a limit on access fees, if any, would be if the Commission were to ban flash orders on the options exchanges.[158]

33. The Commission requests comment on whether there are alternative methods other than the

[148] As noted above, if a market maker is charged a payment for order flow fee by an exchange when the market maker is accessing the best bid or offer of the exchange, then the proposed fee limitation would apply to that fee because it would be a fee for the execution of an order against the best bid or offer of the exchange. *See supra* Section III.C (discussing payment for order flow fees).

[149] *See* IB Letter, *supra* note 37, at 1 and 6–7.

[150] *See* Wolverine Letter, *supra* note 37, at 3.

[151] *See supra* note 116 and accompanying text.

[152] *See supra* notes 117–118 and accompanying text.

[153] *See* Options Concept Release, *supra* note 21, at 6131. *See also supra* note 128.

[154] *See* Options Concept Release, *supra* note 21, at 6131.

[155] *See* Citadel Petition, *supra* note 34, at 5, and Ameritrade Letter, *supra* note 37, at 11.

[156] *See* BOX Letter, *supra* note 37, at 3; IB Letter, *supra* note 37, at 6; NYSE Euronext Letter, *supra* note 37, at 3–4; and GETCO Letter, *supra* note 37, at 7.

[157] *See supra* note 13.

[158] *See* Flash Order Proposal, *supra* note 19.

proposed access fee cap to achieve the objectives of the proposal—to provide for fair and efficient access to displayed quotations and that displayed quotations be fair and useful. For example, could additional disclosure of fees charged by exchanges for executions against their quotations in listed options achieve the same objectives by fostering further competition based on transparent pricing? Why or why not? Please address current disclosure by options exchanges of their fees, and why that disclosure is or is not sufficient.

34. The Commission requests comment on whether, if it were to adopt the proposed access provisions, a phase-in period would be necessary to allow exchanges and market participants to adapt. If so, what aspect or aspects of the proposal should be phased in, and what would be the appropriate phase-in period?

The Commission recognizes that intermarket access presents a number of complex problems to which there may be many possible solutions. Interested persons may wish to propose and discuss specific, alternative approaches to intermarket access that the Commission should consider for future rulemaking as it seeks to accomplish its goal of strengthening the NMS. Commenters may also wish to discuss whether there are any reasons why the Commission should consider an alternative approach.

VI. Paperwork Reduction Act

The Commission preliminarily does not believe that the proposed amendments to Rule 610(a) pertaining to quotations in a listed option and the proposed access fee limitation in Rule 610(c)(2) contain any "collection of information" requirements as defined by the Paperwork Reduction Act of 1995, as amended ("PRA").[159] The proposed amendment to Rule 610(a) would expand the rule to apply to listed options, in addition to NMS stocks, and would prohibit each national securities exchange or national securities association from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member of such exchange or association to any quotation in an NMS security. The Commission preliminarily does not believe that the prohibition in Rule 610(a), as proposed to be amended to apply to listed options, would require any new or additional collection of information, as such term is defined in the PRA, but the Commission encourages comments on this point.[160]

In addition, proposed Rule 610(c)(2) would prohibit a national securities exchange from imposing, or permitting to be imposed, any fee or fees for the execution of an order against a quotation that is the best bid or best offer of such exchange in a listed option that exceeds or accumulates to more than $0.30 per contract. The Commission preliminarily does not believe that the access fee limitation in proposed Rule 610(c)(2) would require any new or additional collection of information, as such term is defined in the PRA, but the Commission encourages comments on this determination.[161]

With respect to a proposed rule change that an options exchange may be required to file pursuant to Section 19(b) of the Exchange Act and Rule 19b–4 thereunder to bring its rules into compliance with the proposed amendment to Rule 610(a) and proposed Rule 610(c)(2),[162] the burden of filing such proposed rule change would already be included under the collection of information requirements contained in Rule 19b–4 under the Exchange Act.[163]

VII. Consideration of Costs and Benefits

The proposed amendments to Rule 610 of Regulation NMS would set forth new standards governing means of access to quotations in listed options. The proposal would prohibit an exchange or association from imposing unfairly discriminatory terms that would prevent or inhibit the efficient access of any person through members of such exchange or association to any quotations in an NMS security, including in a listed option, displayed through its SRO trading facility. In addition, to ensure the fairness and accuracy of displayed quotations in listed options, proposed Rule 610(c)(2) would establish an outer limit on the cost of accessing the best bid and best offer on each exchange in a listed option of no more than $ 0.30 per contract.

A. Benefits

The Commission preliminarily believes that the proposed amendments to Rule 610 of Regulation NMS would help achieve the statutory objectives for the NMS by promoting fair and efficient access to each individual options exchange.

1. *Proposed Amendment to Rule 610(a)*

The access provision of Rule 610(a), as proposed to be amended, is designed to strengthen the ability of all market participants that are not members of an options exchange to fairly and efficiently route orders to execute against quotations in a listed option, wherever such quotations are displayed in the NMS, by prohibiting an exchange from unfairly discriminating against any person trying to obtain access through a member to that exchange's quotations. The Commission believes that fair and efficient access to the best displayed quotations of all options exchanges is critical to achieving best execution of those orders.[164] The Commission further believes that such fair and efficient

[159] 44 U.S.C. 3501, *et seq.*

[160] *See* 44 U.S.C. 3502(3) (defining the term "collection of information" to include, generally, the obtaining, causing to be obtained, soliciting, or requiring the disclosure to third parties or the public, of facts or opinions by or for an agency, regardless of form or format, calling for either: (i) Answers to identical questions posed to, or identical reporting or recordkeeping requirements imposed on, ten or more persons, other than agencies, instrumentalities, or employees of the United States; or (ii) answers to questions posed to agencies, instrumentalities, or employees of the United States which are to be used for general statistical purposes).

The Commission notes that the requirement under the proposed amendment to Rule 610(a) is substantially similar to current Rule 610(a) of Regulation NMS. *See* 17 CFR 242.610(a). The Commission requested comment on its preliminary view that Rule 610 of Regulation NMS pertaining to access to quotations in an NMS stock did not contain a collection of information requirement as defined by the PRA. *See* Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126, 11160–61 (March 9, 2004) (File No. S7–10–04) ("Regulation NMS Proposing Release"). The Commission notes that no comments were received that addressed whether Rule 610(a) contained a collection of information requirement. *See* Securities Exchange Act Release No. 50870 (December 16, 2004), 69 FR 77424, 77476 (December 27, 2004) ("Regulation NMS Reproposing Release").

[161] The Commission notes that proposed Rule 610(c)(2) is substantially similar to current Rule 610(c) of Regulation NMS. *See* 17 CFR 242.610(c). The Commission requested comment on its preliminary view that Rule 610 of Regulation NMS pertaining to a limit on access fees did not contain a collection of information requirement as defined by the PRA. *See* Regulation NMS Proposing Release, *supra,* note 160, at 11160–61. The Commission notes that no comments were received that addressed whether the proposed access fee cap under Rule 610 contained a collection of information requirement. *See* Regulation NMS Reproposing Release, *supra* note 160, at 37577 n.746.

[162] *See infra* Section VII.B.

[163] *See* Securities Exchange Act Release No. 50486 (October 5, 2004), 69 FR 60287, 60293 (October 8, 2004) (File No. S7–18–04) (describing the collection of information requirements contained in Rule 19b–4 under the Exchange Act). The Commission has submitted revisions to the current collection of information titled "Rule 19b–4 Filings with Respect to Proposed Rule Changes by Self-Regulatory Organizations" (OMB Control No. 3235–0045). According to the last submitted revision concluded as of August 5, 2008, the current collection of information estimates 1279 total annual Rule 19b–4 filings with respect to proposed rule changes by self-regulatory organizations.

[164] *See* NMS Adopting Release, *supra* note 4, at 37539.

access to the best displayed quotations of options exchanges is critical for compliance with the requirements of the Trade-Through Rules. Specifically, options exchanges themselves must have the ability to route orders for execution against the displayed quotations of other exchanges. Indeed, the concept of intermarket protection against trade-throughs is premised on the ability of options exchanges to route orders to execute against, rather than trade through, the quotations displayed by other options exchanges.[165]

Thus, the Commission preliminarily believes that the proposed amendment to Rule 610(a) would benefit investors by furthering the ability of brokers on behalf of their customers, and of investors themselves, to achieve best execution of their orders in listed options. The Commission also preliminarily believes that the proposed amendment to Rule 610(a) would contribute to the smooth functioning of intermarket trading by furthering the ability of options exchanges and market participants, including investors, to fairly and efficiently access the quotations of each options exchange.[166]

The proposed amendment to Rule 610(a) also would help to clarify when certain terms set by exchanges would be unfairly discriminatory, including terms in current exchange rules. For example, an exchange could not charge a higher per-contract access fee to a non-member broker-dealer that is a registered options market maker on another exchange ("non-member market maker") acting for its own account than to a member or non-member broker-dealer acting for its own account that is not registered as a market maker on another exchange. In this example, neither broker-dealer is registered as, nor is acting in the capacity of, a market maker on that exchange.[167] The Commission preliminarily believes that this type of distinction could unfairly discriminate against non-member market makers and prevent or inhibit such non-member market makers from obtaining efficient access through a member to that exchange's quotations. Similarly, an exchange could not charge differing fees for accessing liquidity depending on whether the order is for the account of a "directed" customer. The Commission preliminarily believes that such a distinction could unfairly discriminate against non-directed customer orders and prevent or inhibit such non-directed customers from obtaining efficient access through a member to that exchange's quotations in certain listed options.

2. *Proposed Rule 610(c)(2)*

The access fee limitation of proposed Rule 610(c)(2) would address the potential distortions caused by substantial, disparate fees. When a displayed quotation does not include the amount of any fee or fees charged by an exchange for executing against that quotation, persons attempting to execute, or evaluating whether they want to execute, against that quotation cannot readily ascertain the all-in price for the trade. The larger the non-displayed fee(s), the less accurate would be the displayed price in comparison to the all-in price for the trade. This concern is compounded when competing exchanges charge differing fees, as the same displayed price on two or more options exchanges may reflect different all-in prices for executing against the same-priced quotations. Thus, the wider the disparity in the level of access fees among different options exchanges, the less useful and accurate may be the quoted prices at reflecting the full cost of a trade. As a result of the proposed fee limitation, quoted prices should in many cases more closely reflect the total cost of a trade because the highest potential access fee that could be charged by any exchange would be $0.30 per contract. This limitation, in turn, should enhance the usefulness of quotation information.

An access fee limit also makes the cost of accessing quoted prices more transparent. Currently, the eight options exchanges charge so many different fees to different categories of options participants and for different products that it is not easy to estimate that total cost of a particular transaction. An access fee cap would limit the scope of differences and therefore would result in quoted prices providing clearer information on the total cost for executing against quoted prices. Consequently, the proposed fee limitation would further the statutory purposes of the Exchange Act by reducing the tendency of access fees to distort quoted prices. In addition, by applying equally to all types of options exchanges, the proposed fee limitation would promote NMS objectives and further the goals of Section 11A of the Exchange Act relating to equal regulation of markets and broker-dealers.[168]

The proposed fee limitation also would benefit the markets and market participants by addressing options exchanges that otherwise might charge high fees to market participants required to access their quotations under the Trade-Through Rules. The requirements under the Trade-Through Rules and the use of private linkages could provide an exchange the opportunity to take advantage of intermarket price protection by acting essentially as a toll booth between price levels. Even though the exchange charging the highest fees likely would be the last exchange to which orders would be routed, orders could not be executed against the next-best price level until someone routed an order to take out the displayed price at such high fee exchange. While exchanges would have significant incentives to compete to be near the top in order-routing priority, arguably there would be little incentive to avoid being the least-preferred exchange if fees were not limited. Such a business model could detract from the usefulness of quotation information and impede market efficiency and competition.[169]

The Commission preliminarily believes that the proposed access fee cap would limit the viability of this business model. Consequently, another benefit of the proposal would be to place all options exchanges on a level playing field with respect to the maximum amount of access fees they can charge, and, ultimately, the rebates they can pay to liquidity providers, by establishing a clear limit on the fees they can charge. Some options exchanges might choose to charge lower fees, thereby increasing their ranking in the preferences of order routers. Others might charge $0.30 per contract and rebate a substantial proportion to liquidity providers.[170] The Commission preliminarily believes that competition will determine which strategy is most successful. Proposed Rule 610(c)(2) also would preclude an options exchange from charging high fees selectively to competitors.

The Commission also preliminarily believes that the proposed access fee

[165] *Id.*

[166] *Id.*

[167] *See supra* note 51 and accompanying text.

[168] *See* Section 11A(c)(1)(F) of the Exchange Act, 15 U.S.C. 78k–1(c)(1)(F) (providing objective to assure equal regulation of all markets for qualified securities and all exchange members, brokers, and dealers effecting transactions in such securities).

[169] *See* NMS Adopting Release, *supra* note 4, at 37584 (concluding that, with respect to NMS stocks, an outlier business model would detract from the usefulness of quotation information and impede market efficiency and competition and that a fee cap would limit such a business model). *See also supra* notes 69–71 and accompanying text.

[170] The Commission notes that nothing in proposed Rule 610(c)(2) would preclude an options exchange from taking action to limit fees beyond what is required by the proposed Rule, and such options exchanges would have flexibility in establishing their fee schedules to comply with proposed Rule 610(c)(2), consistent with existing requirements of the Exchange Act and the rules and regulations thereunder.

limitation would further the purposes of Section 11A(c)(1)(B) of the Exchange Act, which authorizes the Commission to adopt rules assuring the fairness and usefulness of quotation information. As discussed above, if options exchanges are allowed to charge high fees and pass most of them through as rebates, the published quotations of such exchanges may not reliably indicate the all-in price that is actually available to investors. For quotations to be fair and useful, there must be some limit on the extent to which the all-in price for those who access quotations can vary from the displayed price. Consequently, the Commission preliminarily believes that the proposed access fee limitation would further the statutory purposes of the NMS by limiting the distortive effects of high fees. Moreover, the Commission preliminarily believes that the proposed fee limitation would further the statutory purpose of enabling broker-dealers to route orders in a manner consistent with the operation of the NMS.[171] Under the Trade-Through Rules, one exchange cannot trade through another exchange displaying the best-priced quotations. The purposes of the Trade-Through Rules would be thwarted if market participants were allowed to charge high fees that distort quoted prices in a listed option.

In proposing amendments to Rule 610, the Commission seeks to help ensure that transactions in listed options can be executed efficiently at any market center for reasonable execution fees. By enabling fair access and transparent pricing among the different market places within a unified national market, the Commission preliminarily believes that the proposal would foster efficiency, enhance competition, and contribute to the best execution of orders in listed options.

Finally, the Commission notes that the current access fee limitation in Rule 610(c) has applied to the trading of NMS stocks for several years and believes that such limitation has not caused any apparent harm to competition among markets or market participants trading NMS stocks. For example, when recently requesting comment on various aspects of equity market structure, the Commission noted how trading volume for NMS stocks is spread out among the registered exchanges, ECNs, dark pools, and broker-dealers that execute trades internally.[172] The Commission notes that, currently, the options exchanges are competitive.[173] As such, the Commission preliminarily believes that an access fee limitation applied to the trading of listed options would not harm competition among exchanges or market participants trading listed options.

The Commission also preliminarily believes that the proposed access provisions would help to assure investors that their orders are executed at the best prices and are not subject to large, non-transparent fees by limiting the difference between the all-in price of an investor executing its order and the displayed quotation, regardless of the exchange on which the execution takes place.

B. Costs

1. *Proposed Amendment to Rule 610(a)*

If the proposed amendment to Rule 610(a) were adopted, it could impose costs associated with modifications to an options exchange's rules to comply with such proposed Rule's specific anti-discriminatory standard for access to an exchange's quotations through a member. The Commission notes, however, that each exchange registered as a national securities exchange is currently subject to similar restrictions in Section 6 of the Exchange Act, including the requirements in Section 6(b)(5) that the rules of a national securities exchanges be designed, among other things, not to permit unfair discrimination between customers, issuers, brokers, or dealers.[174] Accordingly, the Commission preliminarily believes that it would be unlikely for the options exchanges to need to amend their rules to comply with Rule 610(a), as proposed to be amended. To the extent that any amendments are necessary, the Commission preliminarily expects such amendments would be minimal. The Commission, therefore, preliminarily believes that any costs incurred as a result of the requirement under the proposed amendment to Rule 610(a) by an options exchange would not be significant.

More specifically, an options exchange that would need to amend its rules to comply with the proposed amendment to Rule 610(a) so as not to unfairly discriminate would be required to file a proposed rule change on Form 19b–4 with the Commission.[175] The Commission further notes that the proposed rule change filing format is not new to the options exchanges, as multiple filings are made annually by such exchanges.[176] The Commission estimates that an average rule change requires approximately 34 hours for an exchange to complete at an average hourly cost of $305.[177] The Commission estimates that the aggregate cost of one proposed rule change for each options exchange, which assumes that every options exchange would have to amend its rules to eliminate any unfairly discriminatory terms not consistent with the proposed amendments to Rule 610(a), would total approximately $82,960 ($305 times 34 times 8). Therefore, the Commission preliminarily believes that the costs incurred by an options exchange to make such a filing as a result of the proposed amendment to Rule 610(a) would not be substantial.[178]

2. *Proposed Rule 610(c)(2)*

The Commission preliminarily does not believe that the fee limitation of

[171] Section 11A(c)(1)(E) of the Exchange Act, 15 U.S.C. 78k–1(c)(1)(E), authorizes the Commission to adopt rules assuring that broker-dealers transmit orders for securities in a manner consistent with the establishment and operation of a national market system.

[172] *See* Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594, 3598 (January 21, 2010) (S7–02–10).

[173] *See infra* Section VIII.A.1 (discussing market share data for January 2010 among the eight options exchanges).

[174] Section 6(b)(5) of the Exchange Act also requires in part that the rules of a national securities exchanges be designed to: (1) Promote just and equitable principles of trade; (2) remove impediments to and perfect the mechanism of a free and open market and a national market system; and (3) protect investors and the public interest. *See* 15 U.S.C. 78f(b)(5). *See also supra* note 47 and accompanying text. No national securities association currently trades listed options.

[175] *See* 15 U.S.C. 78s(b) (requiring each SRO to file with the Commission, in accordance with such rules as the Commission may prescribe, copies of any proposed rule or any proposed change in, addition to, or deletion from the rules of such SRO, accompanied by a concise general statement of the basis and purpose of such proposed rule change). *See also* 17 CFR 240.19b–4(a) (generally requiring that filings with respect to proposed rule changes by an SRO be made on Form 19b–4, 17 CFR 249.819).

[176] The Commission notes that, for its 2009 fiscal year (October 1, 2008 to September 30, 2009), the seven options exchanges (NYSE Amex, BOX, CBOE, ISE, NOM, NYSE Arca, and Nasdaq OMX Phlx) filed approximately 444 proposed rule changes in the aggregate pursuant to Section 19(b) and Rule 19b–4 thereunder.

[177] The $305 per-hour figure for an attorney is from SIFMA's *Management & Professional Earnings in the Securities Industry 2008,* modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. *See* Securities Exchange Act Release No. 59748 (April 10, 2009), 74 FR 18042, 18093 (April 20, 2009) (S7–08–09) (noting the Commission's modification to the $305 per hour figure for an attorney).

[178] The Commission also notes that each options exchange should already have in place policies and procedures to ensure that terms of access to its market are consistent with the federal securities laws and the rules thereunder. *See supra* note 174 and accompanying text. The Commission preliminarily believes that such options exchange's existing policies and procedures should not change as a result of the proposed amendments to Rule 610, and, therefore, should not incur any new costs, including administrative costs, in this regard.

proposed Rule 610(c)(2) would impose significant new costs on the options exchanges or market participants. The Commission preliminarily believes that the proposed fee limitation would be relatively easy to administer given that it would impose a single accumulated access fee limitation for all options. For options exchanges that currently charge and collect fees and that would continue to do so, the costs of imposing and collecting fees are already incurred. The fee limitation would not require an options exchange that does not currently charge fees to begin charging fees. Thus, the Commission preliminarily believes that the proposed fee limitation should not impose significant new administrative costs.

The Commission recognizes that the fee limitations of proposed Rule 610(c)(2) would affect options exchanges that currently impose access fees in excess of the proposed limits. As a result of the access fee limitations of proposed Rule 610(c)(2), such options exchanges would be required to modify their respective rules to ensure compliance with the proposed Rule's fee cap. The Commission preliminarily believes, however, that the potential administrative costs associated with any necessary changes to the rules of an options exchange that may be needed to account for the proposed access fee limitation would not be substantial. The Commission notes that an options exchange that would need to amend its rules and fee schedule to comply with the access fee limitation as a result of proposed Rule 610(c)(2) would be required to file a proposed rule change on Form 19b–4 with the Commission.[179] The Commission further notes that the proposed rule change filing format and the process to change a due, fee, or other charge applicable only to members is not new to the options exchanges, as multiple fee filings are made annually by such exchanges.[180] As stated above, the Commission estimates that an average rule change requires approximately 34 hours for an exchange to complete at an average hourly cost of $305.[181] The Commission estimates that the aggregate cost for all options exchanges of one proposed rule change for each exchange would total approximately $82,960.[182] Therefore, the Commission preliminarily believes that the costs incurred by an options exchange to make such a filing as a result of proposed Rule 610(c)(2) would not be substantial.[183]

The Commission also recognizes that, as a result of the proposed access fee limitation, certain options exchanges that currently charge access fees that exceed, or accumulate to more than, $0.30 per contract would be required to reduce their access fees, and that this action could result in a reduction in revenue from transaction fees for those exchanges.

The Commission preliminarily estimates that the imposition of an access fee cap, as proposed, could reduce option exchanges' annual transaction fee revenues by about $74 million under a flat $0.30 access fee cap.[184] The estimated revenue losses per exchange are set forth in Table 3 of the Appendix. Commission staff estimates the proportion of fee losses to total fees for December 2009 and applies that proportion to the annual transaction fee revenue for each exchange. The Commission staff utilized OCC data that contains aggregate two-sided volume data by account type (customer, firm or market maker). In order to estimate the impact on each option exchange's revenues,[185] Commission staff makes a number of assumptions:

- Commission staff assumes that the options exchanges that impose fees in excess of the proposed access fee cap would not adjust their rebates or other fees to offset any shortfalls on revenues imposed by the access fee cap.
- Commission staff looked at a range of fees that each options exchange charges for accessing the best bid or offer in listed options on the exchange, based on its published fee schedule.[186] The fee ranges include any fee that is charged for execution of an order against an exchange's best bid or offer. Thus, they include "Take" fees, transaction fees, index "licensing" fees, certain payment for order flow fees, and ORF. The fee ranges exclude fees charged for transactions in FLEX options, credit default options, and the fee that ISE charges for transactions by broker-dealers registered as market makers on other exchanges. Commission staff has excluded these specific transaction fees from these calculations because it preliminarily believes that the volume of transactions and the corresponding assessed transaction fees are not significant, but requests comment on whether such fees should be included in the cost impact calculation. Any available volume discounts also are not taken into account because such discounts are variable and if applied would reduce the cost estimates. Tables 1 and 2 of the Appendix show the fee ranges used in estimating the revenue impact.
- To estimate the impact on each option exchange's revenues, the Commission staff generally assumes the maximum possible fee for electronically transmitted orders grouped by account type, whether or not the class is included in the Minimum Quoting Increment Pilot Program, and option type. This assumption would lead, conservatively, to higher estimates of

[179] *See supra* note 175.

[180] An exchange generally would be able to amend its fees imposed on its members by filing a proposed rule change pursuant to Section 19(b)(3)(A) of the Exchange Act of Rule 19b–4(f)(2) thereunder. *See* 15 U.S.C. 78s(b)(3)(A) and 17 CFR 240.19b–4(f)(2) (permitting proposed rule changes that establish or change a due, fee, or other charge applicable only to members to take effect upon filing with the Commission). The Commission notes that, for its 2009 fiscal year, the seven options exchanges filed approximately 120 proposed rule changes in the aggregate pursuant to Section 19(b)(3)(A) of the Exchange Act and Rule 19b–4(f)(2) thereunder. *See supra* note 176 (noting the approximate total of all proposed rule changes filed by the options exchanges pursuant to Section 19(b) and Rule 19b–4 thereunder during the same time period).

[181] *See supra* note 177.

[182] The Commission notes that if an exchange were required to submit a proposed rule change to address a rule or fee that was not consistent with the anti-discriminatory standard proposed in Rule 610(a), as well as a fee that exceeds the proposed fee cap, the exchange could choose to submit one rule filing that would make changes necessary to comply with proposed Rules 610(a) and 610(c)(2) to reduce costs.

[183] The Commission also notes that each options exchange should already have in place policies and procedures to ensure that all of the fees it charges, including access fees, are consistent with the federal securities laws and the rules thereunder. The Commission preliminarily believes that, while an options exchange may be required to amend its fee schedule to account for the proposed access fee limitation, such options exchange's existing policies and procedures should not change as a result of the proposed amendments to Rule 610, and therefore, should not incur any new costs, including administrative costs, in this regard.

[184] For this estimate, Commission staff used December 2009 option trading data from OCC and OptionMetrics. The Commission staff estimates that if the Commission were to impose a fee cap of 0.3 percent of the price of the option for options priced below $1—similar to the existing cap for NMS stocks—the potential reduction in revenue for the options exchanges would be $177 million.

The Commission has not included BATS in these revenue impact calculations. As noted below, BATS recently started trading options on February 26, 2010. *See infra* note 197. Further, BATS' only transaction fee for listed options is $0.30 per contract for removing liquidity (and a $0.20 per-contract rebate for providing liquidity). *See* BATS Fee Schedule (available at *http://batstrading.com/resources/regulation/rule_book/BATS_Ex_Fee_Schedule.pdf*) (current as of February 26, 2010).

[185] *See infra* note 187 and accompanying text for an estimate of the impact of the proposed access fee cap on transaction fee revenues using an assumption that the options exchanges that have a Make or Take fee model reduce their "Make" fees to compensate for a reduction in "Take" fees.

[186] The fees used are as of January 2010, except that they do not include fees or credits imposed by Nasdaq OMX Phlx in SR–Phlx–2009–116, SR–Phlx–2010–14, and SR–Phlx–2009–104, which filings were abrogated by the Commission on February 19, 2010. *See* Securities Exchange Act Release No. 61547 (February 19, 2010), 75 FR 8762 (February 25, 2010).

revenue losses. Further, because fee levels for equity options tend to be different than fee levels for index options, and because the fee levels for classes included in the Minimum Quoting Increment Pilot Program sometimes are different than the fee levels for classes not included in that Pilot Program, Commission staff estimates fees separately for each.

- Commission staff assumes that access fees only apply to "Takers" of liquidity at a particular exchange. Staff further assumes that customers always "take" liquidity, market makers always "make" liquidity, and firms make up the difference. Based on December 2009 data, Commission staff estimates that average firm volume by option class is about 52% on the "take" side and 48% on the "make" side.
- The OCC classifies cleared trades based on OCC membership rather than exchange membership. Therefore, Commission staff assumes that the OCC "firm" classification applies to both member and non-member firms at a particular exchange. If a particular exchange charges different levels of fees for member and non-member firms, Commission staff conservatively assumes the maximum fee applies to all trades classified as "firm" accounts.

As noted above, this cost estimate assumes that the exchanges do not make any changes to their other fees in response to the proposed access fee cap. Options exchanges may, however, respond to access fee limits by restructuring their fee schedules to mitigate the effect of the proposed fee cap. For example, the impact of imposing a fee limitation in a Make or Take fee model may be mitigated if exchanges using such fee model reduce the rebates to reflect the reduced "Take" fees. In such a case, the net impact on exchange revenue would be less than the amount by which an exchange is required to reduce its "Take" fee because the exchange would pay a smaller rebate to members providing liquidity. In addition, certain options exchanges may simply be able to re-calibrate existing fee structures to offset potential revenue losses, while other exchanges may decide to charge additional fees to make up for potential revenue losses.

Options exchanges have the ability, consistent with the requirements of the Exchange Act, to levy fees on their members. Currently, exchanges charge their members various types of fees for membership, transacting on the exchange, and for other services provided by the exchange, including connectivity fees, regulatory fees, and other fees. The Commission preliminarily believes that exchanges are likely to amend their fees that would not be impacted by the access fee limitation to make up for the reduction in access fee revenue, thus keeping the overall level of fees paid by members, and the amount of revenue received by the exchange, relatively constant. Further, the Commission preliminarily believes that exchanges that provide rebates to liquidity providers based on the amount of fees the exchanges charge for accessing liquidity may reduce such rebates commensurate with any reduction in the fees charged for accessing liquidity. In this event, the amount of revenue received by the exchange—the difference between the "Take" fee and the "Make" rebate—would remain constant. If exchanges with "Make or Take" models reduce their "Make" fees to compensate for a reduction in "Take" fees due to the proposed access fee cap, the Commission estimates that the imposition of an access fee cap as proposed could reduce option exchanges' transaction fee revenues by about $55 million under a flat $0.30 access fee cap.[187]

The Commission also preliminarily believes that the overall cost to members of exchanges from the proposal to limit access fees would be minimal. As noted above, exchange members pay various types of fees to their exchanges, including transaction fees, regulatory fees, and other fees. Some of these fees are charged for activity by the members' customers or other non-member market participants that comes through members. Exchange members today can choose to pass through these fees to their customers, or not, subject to competition among members for this order flow. As outlined above, the Commission preliminarily believes that the overall revenue to the exchanges—and thus the overall fees charged by exchanges to members—would remain constant, although the levels of fees within individual fee categories may change. Thus, the impact of fee changes on individual members and market participants may vary, depending upon each participant's business structure and trading strategies, and depending upon what portion of the fees each member chooses to "pass through" to its customers.

C. Request for Comment

The Commission requests general comment on the costs and benefits of the proposed amendments to Rules 610(a) and (c) of Regulation NMS discussed above, as well as any costs and benefits not already described which could result from them. The Commission also requests data to quantify any potential costs or benefits.

The Commission specifically requests comment on the cost estimates made, and the assumptions underlying those cost estimates as outlined, in Section VII.B.2. For example, do commenters believe that options exchanges that currently impose fees in excess of the fee cap proposed in Rule 610(c)(2) would or would not adjust their rebates or other fees to offset the impact of a fee cap? If commenters believe that options exchanges would adjust their rebates or other fees to offset the impact of a fee cap, what specific types of changes would exchanges make? Further, depending upon the specific change to rebates or fees that commenters believe exchanges would make in response to the proposed fee cap, how do commenters believe that such change(s) would impact the quoting, order routing, or other behavior of particular categories of market participants, such as retail investors, market makers, and broker-dealers?

Do commenters believe that it is appropriate generally to consider the maximum fee charged for electronically transmitted orders in calculating the impact on an options exchange's revenue of the proposed access fee cap? If so, please explain why. If not, please provide detail as to what assumptions should underlie such a calculation. Further, do commenters agree that it is reasonable to exclude specific fees charged for the execution of orders in FLEX options or credit default options, and the fee that ISE charges for transactions by broker-dealers registered as market makers on other exchange, as well as volume discounts, when determining the maximum fee charged by options exchanges? Do commenters agree with the assumption that customers always "take" liquidity, market makers always "make" liquidity, and firms make up the difference? If not, please provide detail as to what assumptions should be made and any supporting information, or describe another approach for estimating the costs of this proposal.

VIII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the

[187] For this estimate, Commission staff used December 2009 option trading data from OCC and OptionMetrics. *See infra* Table 3 in the Appendix.

protection of investors, whether the action would promote efficiency, competition, and capital formation.[188] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition.[189] Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[190]

A. Competition

The Commission begins its consideration of potential competitive impacts with observations of the current structure of the option markets and broker-dealers, mindful of the statutory requirements regarding competition. Based on the Commission's experience in regulating the options markets and broker-dealers, including reviewing information provided by them in their registrations and filings with the Commission and approving such registration applications, the Commission discusses below the basic framework of the markets they comprise.

1. Market Structure for Options Markets

In order to consider whether the proposed rules promote competition, staff of the Commission's Division of Risk, Strategy, and Financial Innovation evaluated the competitive structure of the exchange-listed options trading industry in the United States. In particular, Commission staff considered the nature of competition between liquidity providers within exchanges and competition between exchanges to attract order flow. Within the options exchanges, multiple market makers, proprietary trading firms, and customers submitting limit orders compete to provide liquidity to incoming market or marketable limit orders. Options exchanges compete for order flow through their quotations and, in some cases, through exchange-sponsored payment for order flow.

In the late 1990s, the Commission took actions in response to concerns that the options industry was not fully competitive. Competition in the listed options market is significantly more rigorous today that it has been in the past, as a result of several developments since 1999. These include the move to multiple listing,[191] the advent of electronic exchanges,[192] the extension of the Commission's Quote Rule to options,[193] the injunction against trading outside of the national best bid and offer,[194] the adoption of market structures on the floor-based exchanges that permit individual market maker quotations to be reflected in the exchange's quotation,[195] and the Minimum Quoting Increment Pilot Program,[196] among other developments.

Among the relevant considerations in assessing the degree of competition in an industry are the number of competitors and concentration of market share. Listed options in the United States are currently traded on eight national securities exchanges, owned by six entities. These eight exchanges are CBOE, ISE, NYSE Arca, NYSE Amex, Nasdaq OMX Phlx, NOM, BOX, and BATS. Based on market share data for January 2010 obtained from the OCC,[197] the exchange with the highest market share of option volume was CBOE, with 29.58%, followed by ISE at 22.86%. The two exchanges owned by NYSE Euronext together had a market share of 25.82% (NYSE Arca had 13.94% and NYSE Amex had 11.88%). The two exchanges owned by The NASDAQ OMX Group, Inc. together had a market share of 19.76% (Nasdaq OMX Phlx had 17.17% and NOM had 2.59%). The BOX had a market share of 1.98%.

Another key factor determining the competitiveness of an industry is the extent to which there are significant barriers to entry. In the Commission's assessment, barriers to entry in providing trading platforms in the options market are higher than they are in the equities market because equities may be traded off exchange while options may not. Thus, new entrants in the options market face the regulatory costs associated with establishing a national securities exchange. These costs are not large enough to prevent entry, as evidenced by the fact that four new option exchanges have entered the industry since 2000,[198] and another is anticipated to begin operations soon.[199] However, it is possible that the economic barriers to entry to the options trading industry may be more significant for participants who do not already have the infrastructure required to operate registered exchanges. With the sole exception of the ISE, every new entrant in the options market since 1973 has been created by participants who were already operating securities exchanges.

Broker-dealers are required to register with the Commission and be a member of at least one SRO. The broker-dealer industry, including market makers, is a competitive industry, with most trading activity concentrated among several dozen larger participants and with thousands of smaller participants competing for niche or regional segments of the market.

There are approximately 5,178 registered broker-dealers, of which approximately 890 are small broker-dealers.[200] Larger broker-dealers often enjoy economies of scale over smaller broker-dealers and compete with each other to service the smaller broker-dealers, who are both their competitors and customers. The reasonably low barriers to entry for broker-dealers are evidenced, for example, by the fact that the average number of new broker-dealers entering the market each year between 2001 and 2008 was 389.[201]

[188] 15 U.S.C. 78c(f).

[189] 15 U.S.C. 78w(a)(2).

[190] *Id.*

[191] *See* Securities Exchange Act Release No. 26870 (May 26, 1989), 54 FR 23963 (June 5, 1989) (S7–25–87).

[192] *See* ISE Exchange Approval, *supra* note 30, 65 FR at 11395; Securities Exchange Act Release Nos. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (approving options trading rules for BOX) ("BOX Approval Order"); 54238 (July 28, 2006), 71 FR 44758 (August 7, 2006) (approving NYSE Arca's OX, a fully automated trading system for standardized equity options intended to replace NYSE Arca's options trading platform, PCX Plus); 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008) (approving options trading rules for NOM) ("NOM Approval Order"); and 61419 (January 26, 2010), 75 FR 5157 (February 1, 2010) (approving BATS Exchange proposal to operate as an options exchange) ("BATS Approval Order").

[193] *See* Securities Exchange Act Release No. 43591 (November 17, 2000), 65 FR 75439 (December 1, 2000).

[194] *See supra* notes 8–16 and accompanying text.

[195] *See, e.g.,* Securities Exchange Act Release No. 47959 (May 30, 2003), 68 FR 34441, 34442 (June 9, 2003) (SR–CBOE–2002–05) (adopting, among other things, amendments to incorporate firm quote requirements in CBOE's rules).

[196] *See supra* notes 28–29 and accompanying text.

[197] Although the Commission approved BATS Exchange's proposal to operate as an options exchange in January 2010 (*see* BATS Approval Order, *supra* note 192), BATS Exchange did not commence options trading operations until February 26, 2010. As a result, there is no market share data for BATS for purposes of this discussion.

[198] *See* ISE Exchange Approval, *supra* note 30; BOX Approval Order, *supra* note 192; NOM Approval Order, *supra* note 192; and BATS Approval Order, *supra* note 192.

[199] *See supra* note 8 (referring to the order approving C2 Options Exchange's application for registration as a national securities exchange).

[200] These numbers are based on a review of 2007 and 2008 FOCUS Report filings reflecting registered broker-dealers, and discussions with SRO staff. The number does not include broker-dealers that are delinquent on FOCUS Report filings.

[201] This number is based on a review of FOCUS Report filings reflecting registered broker-dealers from 2001 through 2008. The number does not include broker-dealers that are delinquent on FOCUS Report filings. New registered broker-dealers for each year during the period from 2001 through 2008 were identified by comparing the unique registration number of each broker-dealer

Continued

2. Discussion of Impacts of Proposed Amendments to Rules 610(a) and 610(c) on Competition

The Commission believes that the estimated costs associated with implementing and complying with the proposed amendments to Rules 610(a) and 610(c) are not so large as to raise significant barriers to entry, or otherwise significantly alter the competitive landscape of the listed options market. Given the reasonably high level of competition for order flow in option markets and among broker-dealers, the Commission believes that this industry would remain competitive, despite the potential costs associated with implementing and complying with the proposed amendments to Rules 610(a) and 610(c), even if those costs influence to some degree the profitability of individual option markets or entry and exit of broker-dealers at the margin.

Trading fees typically constitute the largest component of revenues for option exchanges. For example, transaction fees accounted for approximately 80.8% of total revenues for the CBOE in 2008. Thus, a change in the fee structure that significantly reduces total fees could potentially have an important impact on industry profits and thus on the ability of smaller exchanges, including potential new entrants, to meet their fixed costs. However, the Commission believes that the proposed access fee limitations would have a limited, if any, negative impact on the profitability of individual option markets because option markets would be able to adjust their fee structures to accommodate the access fee cap. Therefore, the Commission preliminarily believes that limiting access fees to $0.30 per contract would not lead to a large reduction in total revenues, and would not put an undue burden on smaller exchanges or new entrants that would result in a decrease in competition in the industry.

The Commission recognizes that a limit on access fees that applies to exchanges utilizing a "Make or Take" market model effectively limits the size of the liquidity rebate that such exchanges can offer, inasmuch as the economic viability of the "Make or Take" model generally requires that the rebate be smaller than the access fee. The Commission also recognizes that effectively limiting the size of the liquidity rebate in this way may limit the ability of exchanges utilizing the "Make or Take" model to attract liquidity. However, the Commission preliminarily believes that the proposal would not unduly burden "Make or Take" fee models. In the "Make or Take" fee model, the market earns the differential between the "make" credit and the "take" fee. The proposal allows for access fees of up to $0.30 per contract and thus can accommodate a $0.30 per-contract differential in "make" credits and "take" fees. The largest differential charged by "Make or Take" model option markets currently is $0.20 per contract, sufficiently within the $0.30 per-contract access fee limit of the proposal. In addition, the Commission observes that the "Make or Take" market model has become the dominant structure in the equity market despite the cap of $0.003 per share, suggesting that a similar cap in the option market would not prevent the "Make or Take" model from succeeding in the option market. The Commission requests comment on this preliminary view.[202]

Further, the proposed rules apply uniformly to exchanges with different markets and fee structures, thereby facilitating the ability of option markets to compete in a level regulatory environment. A fee limitation is necessary to preclude individual markets from having fee structures that take improper advantage of the protection against trade-throughs in the Trade-Through Rules. Precluding option markets from taking improper advantage of trade-through protection and making sure that all option markets compete under the same regulatory landscape should strengthen the ability of option markets to compete fairly for business.

The Commission believes that the proposed access fee limitations may have benefits that enhance quote competition among markets. The proposed access fee provisions are intended to bolster transparency in the options markets by improving the integrity of the quotations and preventing large, non-transparent fees from being charged on orders that are being sent to a particular market in order to comply with the trade through provisions of the Trade-Through Rules. Since quotation information would be more informative under the proposed access fee limitations, the Commission expects that the proposed amendments would likely encourage quote competition. Moreover, the Commission preliminarily believes that, by prohibiting a national securities exchange or national securities association from imposing unfairly discriminatory terms that would prevent or inhibit the efficient access of any person through members or non-member subscribers, the proposed rule would promote competition to offer the best displayed quotation among exchanges that trade listed options.

The Commission also believes that the proposal would have a minimal effect on the competitiveness of the broker-dealer industry. Since the proposal seeks to limit access fees, the proposal may result in a reduction in fees paid by broker-dealers to options exchanges. On the other hand, it is possible that options exchanges could increase broker-dealer fees, including market maker fees, to offset any revenue losses from an access fee limit. However, since transaction fee costs are typically a small part of the total expenses for a broker-dealer, the Commission preliminarily believes that any increase in transaction fee costs for broker-dealers would have a minimal, if any, effect on the competitiveness of the broker-dealer industry. The Commission seeks comment, however, on the level of options exchange-levied fees on broker-dealers and whether an increase in these fees would inhibit the competitiveness of the broker-dealer industry.

In summary, the Commission preliminarily believes that the proposal would not result in an undue burden on the competitiveness of any option markets and, as a result, would not result in any decrease in competition among option markets. Moreover, the Commission preliminarily believes that the proposal would promote quote competition in options. The Commission also preliminarily believes that the proposal would not result in an undue burden on the competitiveness of the broker dealer industry.

B. Capital Formation

A purpose of the proposed amendments to Rules 610(a) and 610(c) is to strengthen transparency and quote competition in the option markets regulated by the Commission which should help make investors more willing to invest, resulting in the promotion of capital formation. Long holdings of equity are integral to capital formation. Fair and robust option markets, in which long holders can hedge risk through the option markets, support the public offerings of the underlying equities by which issuers raise capital and, as a result, investors who provided private capital realize profits and manage risk. Therefore, the Commission preliminarily believes that the proposed amendments to Rules 610(a) and 610(c) would increase transparency and quote competition, thereby enhancing investment, and thus capital formation.

filed for the relevant year to the registration numbers filed for each year between 1995 and the relevant year.

[202] *See also* Section V (Request for Comment).

C. Efficiency

The access provision of Rule 610(a), as proposed to be amended, is designed to strengthen the ability of all market participants that are not members of an options exchange to fairly and efficiently route orders to execute against quotations in a listed option, wherever such quotations are displayed in the NMS, by prohibiting an exchange from unfairly discriminating against any person trying to obtain access through a member to that exchange's quotations. Fair and efficient access to the best displayed quotations of all options exchanges is necessary to achieving best execution of those orders.[203] Further, fair and efficient access to the best displayed quotations of options exchanges is necessary for compliance with the requirements of the Trade-Through Rules. Specifically, options exchanges themselves must have the ability to route orders for execution against the displayed quotations of other exchanges. Indeed, the concept of intermarket protection against trade-throughs is premised on the ability of options exchanges to route orders to execute against, rather than trade through, the quotations displayed by other options exchanges.[204] In this way, fair and efficient indirect access would, through the enhancement of the ability to achieve best execution and the support of compliance with the Trade-Through Rules, increase the efficiency of executions across option markets.

The proposed access fee limit would apply equally to all national securities exchanges, thereby promoting the NMS objective of equal regulation of markets. A fee limitation is necessary to preclude individual markets from having fee structures that take improper advantage of the protection against trade-throughs in the Trade-Through Rules. Precluding option markets from taking improper advantage of trade-through protection and making sure that all option markets compete under the same regulatory landscape should strengthen the ability of option markets to compete on a more level playing field, thereby promoting efficiency of execution across option markets by reducing costs.

The Commission solicits comments on these matters with respect to the proposed amendments to Rules 610(a) and (c). Would the proposed amendments have an adverse effect on competition that is neither necessary nor appropriate in furtherance of the purposes of the Exchange Act? Would the proposed amendments, if adopted, promote efficiency, competition, and capital formation? Commenters are requested to provide empirical data and other factual support for their views if possible.

IX. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[205] the Commission must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (1) An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review.

The Commission requests comment on the potential impact of the proposed amendments to Rule 610 on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

X. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act ("RFA")[206] requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)[207] of the Administrative Procedure Act,[208] as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on "small entities."[209] Section 605(b) of the RFA specifically states that this requirement shall not apply to any proposed rule or proposed rule amendment, which if adopted, would not "have a significant economic impact on a substantial number of small entities."[210]

The proposed amendment to Rule 610(a) of Regulation NMS would prohibit a national securities exchange or national securities association from imposing unfairly discriminatory terms that would prevent or inhibit any person from obtaining efficient access through a member of such exchange or association to the quotations in a listed option. In addition, proposed Rule 610(c)(2) would prohibit a national securities exchange from imposing, or permitting to be imposed, any fee or fees for the execution of an order against any quotation that is the best bid or best offer of such exchange in a listed option that exceeds or accumulates to more than $0.30 per contract. As such, only national securities exchanges registered with the Commission under Section 6 of the Exchange Act and national securities associations registered with the Commission under Section 15A of the Exchange Act would be subject to the proposed amendments to Rules 610(a) and (c). None of the national securities exchanges registered under Section 6 of the Exchange Act or national securities associations registered with the Commission under Section 15A of the Exchange Act that would be subject to the proposed amendments are "small entities" for purposes of the RFA.[211] Accordingly, the Commission preliminarily does not believe that the proposed amendments to Rule 610 would have a significant economic impact on a substantial number of small entities.

The Commission invites commenters to address whether the proposed rules would have a significant economic impact on a substantial number of small entities, and, if so, what would be the nature of any impact on small entities. The Commission requests that commenters provide empirical data to support the extent of such impact.

[203] *See* NMS Adopting Release, *supra* note 4, at 37539.

[204] *Id.*

[205] Pub. L. No. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

[206] 5 U.S.C. 601 *et seq.*

[207] 5 U.S.C. 603(a).

[208] 5 U.S.C. 551 *et seq.*

[209] Although Section 601(b) of the RFA defines the term "small entity," the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term small entity for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0–10, 17 CFR 240.0–10. *See* Securities Exchange Act Release No. 18452 (January 28, 1982), 47 FR 5215 (February 4, 1982) (File No. S7–879).

[210] *See* 5 U.S.C. 605(b).

[211] *See* 17 CFR 240.0–10(e). Paragraph (e) of Rule 0–10 states that the term "small business," when referring to an exchange, means any exchange that has been exempted from the reporting requirements of Rule 601 of Regulation NMS, 17 CFR 242.601, and is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in Rule 0–10. Under this standard, none of the exchanges subject to the proposed amendments to Rule 610 is a "small entity" for the purposes of the RFA. The Financial Industry Regulatory Authority or "FINRA" (f/k/a the National Association of Securities Dealers or "NASD") is not a small entity as defined by 13 CFR 121.201.

XI. Statutory Authority

Pursuant to the Exchange Act and particularly, Sections 2, 3(b), 5, 6, 11A, 15, 15A, 17(a) and (b), 19, and 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78e, 78f, 78k–1, 78o, 78o–3, 78q(a) and (b), 78s, and 78w(a), the Commission proposes to amend Rule 610 of Regulation NMS, as set forth below.

Text of Proposed Rule

List of Subjects in 17 CFR Part 242

Brokers, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II, of the Code of Federal Regulations is proposed to be amended as follows.

PART 242—REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

1. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k–1(c), 78*l*, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd–1, 78mm, 80a–23, 80a–29, and 80a–37.

2. Amend § 242.610 by revising paragraphs (a) and (c) to read as follows:

§ 242.610 Access to quotations.

(a) *Quotations of an SRO trading facility.* A national securities exchange or national securities association shall not impose unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member of the national securities exchange or national securities association to the quotations in an NMS security displayed through its SRO trading facility.

* * * * *

(c) *Fees for access to quotations.* (1) A trading center shall not impose, nor permit to be imposed, any fee or fees for the execution of an order against a protected quotation of the trading center or against any other quotation of the trading center that is the best bid or best offer of a national securities exchange or the best bid or best offer of a national securities association in an NMS stock that exceed or accumulate to more than the following limits:

(i) If the price of a protected quotation or other quotation is $1.00 or more, the fee or fees cannot exceed or accumulate to more than $0.003 per share; or

(ii) If the price of a protected quotation or other quotation is less than $1.00, the fee or fees cannot exceed or accumulate to more than 0.3% of the quotation price per share.

(2) A national securities exchange shall not impose, nor permit to be imposed, any fee or fees for the execution of an order against a quotation that is the best bid or best offer of such exchange in a listed option that exceed or accumulate to more than $0.30 per contract.

* * * * *

By the Commission.

Dated: April 14, 2010.

Elizabeth M. Murphy,

Secretary.

Note: The following appendix will not appear in the Code of Federal Regulations.

Appendix

TABLE 1—RANGE OF CHARGES FOR ACCESSING QUOTATIONS*

Exchange	Equity options		Index options	
	Classes included in minimum quoting increment pilot	Classes not included in minimum quoting increment pilot	Classes included in minimum quoting increment pilot	Classes not included in minimum quoting increment pilot
NYSE Amex	$0.00 to $0.42	$0.00 to $0.82	$0.00 to $0.64	$0.00 to $1.04.
NYSE Arca	$0.45	$0.00 to $0.81	$0.45 to $0.67	$0.00 to $1.03.
BOX	−$0.147 to $0.10	−$0.547 to −$0.30	−$0.147 to $0.32	−$0.547 to −$0.08.
CBOE	$0.004 to $0.45	$0.004 to $0.85	$0.004 to $0.60	$0.004 to $1.00.
ISE	$0.0035 to $0.43	$0.0035 to $0.83	$0.0035 to $0.65	$0.0035 to $1.05.
NOM	$0.35 to $0.45	−$0.20 to $0.45	$0.35 to $0.45	−$0.20 to $0.45.
Nasdaq OMX Phlx	$0.0035 to $0.56	$0.0035 to $1.01	$0.30 to $0.45	$0.30 to $0.45.

* As noted above, the Commission has not included BATS in its revenue impact calculations. *See supra* note 184.

TABLE 2—RANGE OF CHARGES FOR PROVIDING SIDE

Exchange	Equity options		Index options	
	Classes included in minimum quoting increment pilot	Classes not included in minimum quoting increment pilot	Classes included in minimum quoting increment pilot	Classes not included in minimum quoting increment pilot
NYSE Amex	$0.00 to $0.42	$0.00 to $0.82	$0.00 to $0.64	$0.00 to $1.04.
NYSE Arca	−$0.30 to −$0.25	$0.00 to $0.81	−$0.25 to $−0.08	$0.00 to $1.03.
BOX	$0.053 to $0.40	$0.553 to $0.80	$0.053 to $0.62	$0.553 to $1.02.
CBOE	$0.004 to $0.45	$0.004 to $0.85	$0.004 to $0.60	$0.004 to $1.00.
ISE	$0.0035 to $0.43	$0.0035 to $0.83	$0.0035 to $0.65	$0.0035 to $1.05.
NOM	−$0.25	$0.00 to $0.30	−$0.25	$0.00 to $0.30.
Nasdaq OMX Phlx	$0.0035 to $0.56	$0.0035 to $1.01	$0.30 to $0.45	$0.30 to $0.45.

TABLE 3—ESTIMATES OF POTENTIAL REVENUE IMPACT ON OPTIONS EXCHANGES

Exchange	Annual transaction fee revenues [1] ($Millions)	$0.30 cap estimated % of revenues impacted	$0.30 cap estimated revenue loss ($Millions)	$0.30 Cap estimated % of revenues impacted assuming make rebate reductions	$0.30 Cap estimated revenue loss ($Millions) assuming make rebate reductions
NYSE Amex	66.5	0.2	0.1	0.2	0.1
NYSE Arca	114.8	26.0	29.8	12.5	14.4
BOX [2]	4.0	0.0	0	0.0	0.0
CBOE	314.5	7.6	23.9	7.6	23.9
ISE	264.9	0.1	0.3	0.1	0.3
NOM	38.3	11.0	4.2	0.0	0.0
Nasdaq OMX Phlx	180.4	8.9	16.1	8.9	16.1
Total	983.4	7.6	74.4	5.6	54.7

[1] The transaction fee revenue amounts are based on either an exchange's 2008 Annual Report, an exchange's 2009 unaudited financial results from information circulars, or annualized from the exchange's latest 2009 10–Q.

[2] Financial data on annual transaction fees are not available for BOX. Therefore, Commission staff annualized its December 2009 fee revenue estimate.

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