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July 9, 2010

Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Securities and Exchange Commission – Release No. 34-61902, File No. S7-09-10; Proposed Amendments to Rule 610 of Regulation NMS

Dear Ms. Murphy:

LiquidPoint, LLC ("LiquidPoint")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's (the "Commission") Release No. 34-61902, File No. S7-09-10 ("Proposed Amendments") relating to access to quotations in listed options as well as fees for such access. LiquidPoint agrees that there is a need to adopt rules assuring fairness and usefulness of quotation information and to achieve the objective of enhanced transparency of quoted prices. Prohibiting unfairly discriminatory terms that inhibit access and establishing a limit on access fees are steps in the right direction.

However, we would like to emphasize certain aspects unique to the listed-option markets, in particular:

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[1] LiquidPoint, a wholly owned subsidiary of BNY ConvergEx Group, LLC, specializes in providing derivatives technology and execution solutions for U.S. listed options traders, including institutional customers and other broker-dealers. LiquidPoint provides electronic direct market access to every U.S. options exchange, as well as advanced trading capabilities that include order execution, order management, order routing and optimization, quality assurance review, and a variety of reporting and books and records capabilities. BNY ConvergEx Group, LLC is a premier provider of investment and execution technology solutions to institutional clients worldwide. We specialize in providing a full array of leading technologies and an integrated platform of performance driven, global trading capabilities supported by a culture of extraordinary client service.

- The complexity of current fee structures and the rate of change to fee structures
- The effect of the fee structures associated with the two business models employed by listed-option exchanges.

<u>The complexity and rate of change of the listed-options fee structures degrades the usefulness and transparency of quotations</u>

While competition fosters innovation, listed option exchanges have increasingly competed through ever more complex fee structures that do not bring the value normally associated with innovation. This complexity currently allows different access fees for each individual option class or broader category, each uniquely exchange-defined market participant, the exchange business model and associated pricing structure, the size of the order, any applicable licensing fees, the minimum trading increment and particular execution functionality (e.g. different order types and auctions). Should an exchange choose to, this complexity could extend to individual option series or category of option series (e.g. a series greater than 10% "out of the money", certain put options greater than 12% "in the money") and further qualified by unique time periods (e.g. only during the 4 business days prior to expiration). In fact, since rule filings to change fee schedules are effective upon filing, fees could change for the balance of a month in certain uniquely defined circumstances. The possibility exists for constantly changing "blue light specials" like discounted access for professional customers, in those five IBM August expiring options with the greatest open interest as calculated on July 1st for the period July 6th through July 15th. The possibilities are endless and despite the proposed fee limitation, the transparency, fairness and usefulness of quotations are currently impaired by the complexity.

The number and frequency of changes to access fees has a similar effect upon the transparency, fairness and usefulness of quotations. During a period in Q1 of this year, the listed-option exchanges submitted 22 fee related filings in 24 business days. This level of activity does not serve the interests of any market participant - except the exchanges. Market participants cannot reconcile the fees they are charged and places an enormous burden on development and maintenance of trade routing and execution technology.

Lack of transparency in "gross" market prices due to the complexity and rate of change of access and routing fees impedes the ability of customers to determine the destination for the best "net" market price and hinders the ability of broker-dealers to live up to their best execution responsibilities.

<u>The interplay of the fee structures of the two business models employed by the listed-option exchanges degrades liquidity for investors.</u>

In the proposed amendments, the Commission correctly is interested in the effect of the proposed fee limitation upon the competing business models in the current options market structure – the "Make or Take" model and the "Broker Payment" model. While LiquidPoint recognizes and agrees with the Commission's view that competing business models has the *potential* to improve the options market structure, a more basic concern is the effect of the disparate fee structures on the investors need to access risk mitigation liquidity. To analyze the effect upon investors, one needs to understand why and how investors use listed-options and the interplay of these business models.

Why and how investors use listed-options highlights the differences between the markets for stocks and options. The Commission correctly noted that liquidity providers price options differently than liquidity providers price NMS stocks. This is due to the nature and function of listed-options contract. The option contract is a financial product designed to manage the risks associated with a position (actual or virtual) in the underlying instrument. These risks, as defined by the option's terms (i.e. call/put, strike price, expiry), are approximations of the risk inherent in a position in the underlying instrument, but do not equate to the same financial product as the underlying security. The difference between pricing multiple, mathematically related options and a single equity security, present a different challenge to each marketplace when seeking or providing liquidity. The listed-option market has been correctly characterized as "quote driven". This means that all related option series must be priced through the use of quotes, in addition to the liquidity of posted orders, to satisfy the basic needs of investors for the customized insurance provided by each option series. The investor looking to satisfy their insurance needs typically is a liquidity taker and does not post orders – unlike the "order driven" equity markets. Additionally, the option quotes of the many firms and individuals that use the mathematically related pricing allows for virtually unlimited amount of liquidity as risks are shifted between option series and participants. Should circumstances denigrate quoting in less active option series; the supply of liquidity in active series will be reduced.

The fee structure of the two competing business models creates a unique set of incentives for quotes and orders. As noted above, quoting in all option series is necessary for both investors to compare the relative costs of different "insurance policies" and for liquidity providers to price them and offset their risks. Although incenting the posting of orders does provide additional liquidity, unlike quotes this liquidity is often based purely upon millisecond opportunities for arbitrage and confined only to actively traded option series under the best of market conditions. Those exchanges with quoting obligations require a commitment to all series and the maximum width between bid and ask. The two fee structures allows for an arbitrage; particularly when there can be widely disparate access fee levels. The cap on access fees does reduce the incentive for *rebate arbitrage*.

This rebate arbitrage does not require any fundamental calculations of theoretical value and risk management that creates an inventory of positions across all series. All that is necessary is the ability to transmit and manage mass orders that simply match or "penny" (improve by .01) the quotes on non-maker taker exchanges operating under the customer priority/pro-rata allocation model. Whenever a trade occurs, the rebate arbitrageur simply needs to "scratch" the trade by taking liquidity for free or a reduced price on a pro rata exchange to net a profit. One effect of this rebate arbitrage strategy is that it can act in a parasitic fashion upon traditional quote-driven markets. Quoting market makers find that the quotes they are providing can simply be mirrored or "pennied" by rebate arbitrageurs on the maker taker exchanges, providing a price "cushion" to a competing business model. If these market makers begin to pull back from posting quotes, rebate arbitrageurs will also need to pull back from posting orders, possibly contributing to the phenomenon known as "dark screens" where very little liquidity is posted except in the most liquid names and front-month, at-the-money option series. Even with fee limitations, the make or take fee structure promotes the ephemeral liquidity of orders in a market that depends upon quotes, at the expense of the customer priority / pro rata exchange model – ultimately to the detriment of the investor. Rebate arbitrage activity benefits the arbitrageurs; not investors and in the short term the exchanges, but ironically, not the long term viability of the listed-option market.

The Commission noted the distinction between "aggressive" quoting and "matching" quoting in the request for comments on the Proposed Amendments. It is ironic that the incentive for posting orders on the maker taker exchanges allows for *matching* of the quotes of the pro rata exchanges by rebate arbitrageurs at the maker taker exchanges. In fact, rebate arbitrage driven liquidity is highly algorithmic and tends to be ephemeral because the basic strategy to capture rebates rather than take intermediate or long-term positions requires market conditions where there is a high probability that the trade can be quickly liquidated for little or no profit. A low volatility environment with strong mean-reversion tendencies is the preferred market condition for the implementation of such strategies Therefore in slow trendless markets there tends to be ample rebate arbitrage driven liquidity available to the marketplace. However, since this incentive offered to provide liquidity does not generally carry any corresponding obligation, when market conditions are less than ideal (i.e., as soon as volatility picks up) rebate-driven liquidity available to the listed-option marketplace tends to vanish. A recent analysis by TABB Group highlights the activity of the options market during the mayhem of May 6th and speaks to the effect of the market structures. "TABB Group compared execution quality statistics on May 6th against execution quality statistics published in the April 2010 Options Liquidity Matrix. Exchanges using the pro-rata market model saw less deterioration in spreads and had larger posted size than price time priority exchanges".

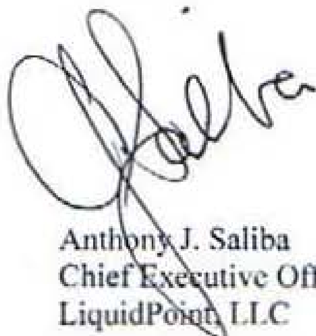
Conclusion

Prohibiting unfairly discriminatory terms that inhibit access and establishing a limit on access fees will *help* assure fairness and usefulness of quotation information and to achieve the objective of enhanced transparency of quoted prices. LiquidPoint feels that the complexity of current fee structures with the great number and frequency of changes are also an impediment to investor's use of quotations and the ability of broker-dealers to provide best execution. The Commission should encourage changes that reduce the complexity and frequency of fee changes; beyond the necessary fee convergence resulting from the access fee cap.

More importantly, the incentive to post orders in the Make or Take model without the obligation to make a two-sided quote (with a maximum width) creates a market dynamic of limited use to option investors, but benefits the short-term interests of the listed-option exchanges. The exchanges increase their transaction revenue by incenting *orders* that create ephemeral liquidity in a market that relies upon *quotes*. The rebate-driven model is detrimental (and even parasitic) to the quote-driven model. The incentive to quote is reduced when other markets incent orders without any obligations; ultimately leading to liquidity limited to certain active option series during periods of low volatility.

Eventually, investors who take liquidity to satisfy their specific risk mitigation needs, often during periods of increased volatility, will no longer find the virtually unlimited supply of liquidity shared across all option series that they currently enjoy.

Sincerely,



Anthony J. Saliba
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LiquidPoint, LLC