imc
financial markets

December 27, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 29549-1090

Re: SEC Release No. 34-61902; File No. S7-09-10

Dear Ms. Murphy,

IMC Chicago, LLC d/b/a IMC Financial Markets ("IMC") appreciates the opportunity to submit this comment letter in response to the request for comment with respect to the Securities and Exchange Commission's ("SEC" or "Commission") proposal to limit exchange access fees for listed options (the "Proposal").

According to the Proposal, the SEC would amend Rule 610(c) of Regulation NMS to prohibit an exchange from charging any fee 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 more than $0.30 per contract (or $0.003 per share). As discussed in detail below, IMC is concerned that the proposed cap will negatively impact the current ability of Maker/Taker exchanges to compete with traditional payment for order flow exchanges. IMC believes in the fundamental principles of transparency and competition. As such, IMC understands the Commission's goal of identifying the outer limits of acceptable access fees, but we believe that market forces should generally be allowed to dictate exchange pricing mechanisms. After balancing these interests, IMC proposes capping exchange access fees for listed options at +$0.49 (rebate) / -$0.50 (take) per contract.

<u>Introduction</u>

IMC is a proprietary trading firm and registered broker-dealer, engaged in providing liquidity in nearly every listed equities and derivatives market in the U.S. In addition, IMC is part of a global firm with affiliates trading in Amsterdam, Zug, Sydney, and Hong Kong.

IMC is a registered market maker in U.S. exchange listed products. As a market maker, IMC establishes two-sided markets which serve to aid investors in their effort to mitigate or transfer risk. IMC's market making strategies use sophisticated risk management controls and innovative technology to safeguard the integrity of its electronic trading system and that of the markets on which we participate.

Discussion

A. Competitive Market Forces Should Determine Pricing Levels

IMC strongly believes in the bedrock principle of competition. Market forces, in an arena of meaningful competition, should dictate the levels and acceptable limits on pricing mechanisms. In the current options marketplace, customers benefit from meaningful competition amongst two distinct models of exchanges: Maker/Taker exchanges and traditional payment for order flow ("PFOF") exchanges. Maker/Taker exchanges typically offer a rebate to market participants for providing liquidity and charge a fee to those who take liquidity. Maker/Taker fees are transparent and apply equally to all similarly situated market participants. PFOF exchanges, on the other hand, assess a fee upon market-makers for trading with customer orders, and a portion of the fee is subsequently directed to order routing firms. These directed payments are opaque in that although the exchange collects the fee, it allows the specialist or preferenced firms to direct payments as they alone deem appropriate. Market makers assessed a PFOF fee for interacting with customer orders, offset the charge by adding it into the spread between its quoted bids and offers. In doing so, the market makers effectively (but not transparently) pass their costs to customers via inferior execution prices. Until Maker/Taker exchanges began competing in the options marketplace, the PFOF model prevailed as the singular pricing structure across exchanges.

Competition amongst these competing models over the past couple of years, however, has resulted in narrower spreads, lower transaction costs, and increased liquidity – to the benefit of all options market participants, particularly customers. IMC is concerned that imposing an artificial cap on access fees will negatively impact the ability of Maker/Taker exchanges to compete with traditional PFOF exchanges. By imposing an artificial cap, the Commission, albeit unintentionally, will create an unlevel regulatory environment amongst competing exchange models and will compromise the competitive viability of Maker/Taker exchanges. Less competition, IMC fears, will only serve to re-strengthen the once dominant pricing structure under the PFOF model –which will necessarily result in inferior prices, higher and more opaque transaction costs, and decreased liquidity.

B. Reasonable Outer Limits Fosters Transparency and Customer Protection

Of course, despite our faith in competition, IMC recognizes that reasonable caps, designed to set outer limits of acceptable fees, may be an appropriate means to protect customers from being economically disadvantaged. When seeking to safeguard customers, however, care must be taken to avoid unintended consequences which in the long run actually harm customers. Imposing a fee cap that is so restrictive it unduly burdens Maker/Taker exchanges ability to effectively compete with PFOF exchanges will ultimately harm customers. Balancing the goals of customer protection and transparent pricing on the one hand, with the principle of meaningful competition on the other hand, therefore, is critical. In this context, as described below, IMC proposes a limitation on fees that facilitates continued and meaningful competition while also establishing reasonable outer limits of access fees.

C. IMC Proposes a +$0.49 (rebate) / -$0.50 (take) Per Contract Access Fee Cap

IMC proposes an access fee cap of +$0.49 (rebate) / -$0.50 (take) per contract.[1] Currently, two distinct versions of the Maker/Taker pricing model exist. NYSE Arca Options ("Arca"), Nasdaq OMX PHLX, Nasdaq Options Market, BATS Options,[2] C2 Options Exchange, and the International Securities Exchange ("ISE") reward market participants for supplying liquidity in certain products via rebates while charging fees to those participants who remove liquidity. In contrast, the Boston Options Exchange ("BOX") inverts this model and charges participants a fee for providing liquidity and offers a rebate to those that remove liquidity. A +$0.49 (rebate) / -$0.50 (take) per contract fee cap addresses both models, as shown below.

> <u>Example:</u>
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> BOX $1.00 bid at $1.02
>
> Arca $1.00 bid at $1.01
>
> Fees: Imagine no fee caps, with ARCA's take fee set at $0.50 cents per contract and BOX's take rebate set at $0.51 per contract.
>
> Result: With a trade on the offer of each exchange, when you add the applicable cost of trading with the displayed prices on each exchange, then a trade would occur at 1.0150 on Arca, but at 1.0149 on BOX. Since the post fee transaction price in this example is better on BOX as compared to Arca, the result is an economic inversion between displayed prices. Such price distortions are not otherwise transparent and harm customers. A proposal that accounts for regular and inverted pricing prevents this distortion from occurring.

IMC's proposed cap also ensures that an apparently better priced quotation does in fact offer net economic benefit to an order routing firm (given the one-tick improvement in price execution). Equally important, a -$0.50 (take) per contract cap offers a reasonable outer limit, which is slightly higher than the currently highest existing take fee ($0.45 per contract). By building in some flexibility above the Commission's $0.30 proposed limit, the proposal allows Maker/Taker fees above $0.30 per contract to subsidize liquidity provider rebates. Maintaining sufficient

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[1] This proposed cap includes access and routing fees, but does not include licensing fees or the Options Regulatory Fee ("ORF").

[2] IMC notes that according to a recent filing, BATS Options plans to offer a $0.50 per contract rebate for any order that adds liquidity to the BATS Options order book that sets a new NBBO, where the adding member has an average daily volume of 20,000 contracts, starting January 3, 2011. *See* SR-BATS-2010-038 (December 21, 2010).

space for Maker/Taker exchanges to compete with PFOF exchanges is vital to maintaining a dynamic marketplace that incents aggressive quoting and tight spreads.

D. Reasonable Fee Caps Eliminate Perceived Need for Step-up Mechanisms

Some have argued that the excessive cost of routing orders to away markets justifies the use of "flash" (or step-up) mechanisms. When flashed, customer orders are delayed while certain market participants are informed of the order and provided an opportunity to execute at the NBBO. In an effort to avoid routing orders to away exchanges, this mechanism not only disadvantages customers—who are not guaranteed any fill during this process—but it also disadvantages participants on Maker/Taker exchanges who had established the NBBO. Flashing also creates a two tiered market, where market participants who are privy to the flash may choose to trade ahead of the customer order or otherwise act on the order information received via the flash as opposed to stepping up to transact at the NBBO. IMC believes that flash mechanisms should be eliminated as they are antithetical to the core principles of transparency, customer protection, and competition. Moreover, establishing reasonable limits on access fees eliminates any economic justification in favor of maintaining flash mechanisms. In other words, since all cap compliant fees would be per se "reasonable", it would no longer be valid to maintain flash mechanisms as a means of avoiding "excessive" transaction fees imposed on routed orders. Accordingly, IMC urges the Commission to eliminate options flash mechanisms with the implementation of a reasonable fee cap as proposed herein.

Conclusion

Although IMC generally believes that market forces should be allowed to dictate exchange pricing mechanisms, we recognize the important goal of identifying the outer limits of acceptable access fees. After balancing these interests, IMC respectfully proposes capping exchange access fees for listed options at +$0.49 (rebate) / -$0.50 (take) per contract. Such a cap ensures fair and transparent pricing, while also facilitating competition between Maker/Taker and PFOF exchanges. Facilitating competition is vital to maintaining a dynamic marketplace that incentivizes aggressive quoting and tight spreads.

IMC appreciates the opportunity to comment on the Commission's Proposal. Should you have any questions in connection with our comments and our proposed alternative, please feel free to contact me at 312-244-3355.

Sincerely,

Andrew Stevens
Legal Counsel

cc:

The Honorable Mary L. Schapiro, Chairman
The Honorable Luis A. Aguilar, Commissioner
The Honorable Kathleen L. Casey, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Elisse B. Walter, Commissioner
Robert W. Cook, Division of Trading and Markets
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