Vanessa Countryman, Secretary

Securities and Exchange Commission

100 F Street, NE

Washington, D 20549-1090

May 5th, 2021

Re: SR_IEX-2021-06

Dear Ms. Countryman:

I would like to thank you for the opportunity to comment on the recent rule proposed by the Investors Exchange (IEX).

The IEX has been revolutionary with respect to creating a better marketplace for long term investors however, I believe this type of rule will create a two-tiered marketplace that could lead to higher bid/ask spreads in the market and lower "fill rates" for large long-term investors.

Professional Customer Status in the Options Market

To analyze the potential risk of approving such a rule, one should look no further than the effects of SR-ISE-2006-26 has had on the options marketplace, where every Options Exchange currently distinguishes customers as either "regular" or "professional" based on the number of orders (390 avg per day) sent per month. The proposed IEX rule uses the same criteria that was introduced in 2009 by the ISE.

As ISE-2006-26 states, the main reason for this rule was that market participants were gaining "retail priority" using "sophisticated trading systems that contain functionality not available to a retail customer, including things such as continuously updated pricing models based upon real-time streaming data". I believe, at the time, the rational for this rule was legitimate and perhaps appropriate. In 2021, however, I believe there is NO real customer "priority" advantage gained by retail options customers because of the following:

1) More strikes and volatile markets

2) Payment for order flow accounting for a majority of customer orders

3) Market fragmentation

4) Price Improvement rules

For example, if you were to create a market trading model (as suggested by the ISE: continuously entering orders to gain priority), you would virtually never gain any priority advantage over Market Makers.

Today, there are over 1.3 million equity options listed (over 2,000 on Apple alone). A regular customer attempting to gain a priority advantage could post one bid and one ask on 195 of those AAPL options (less than

10% of strikes) and likely would be able to hold this advantage for perhaps a couple seconds each day. Upon studying price movements in today's marketplace, I found it very interesting to see just how long one could gain this advantage (being on the bid and ask continuously) on just "one" equity option. I looked at how many price/quantity movements take place at the NBBO level using OPRA's data feed and I found that, on average you could gain customer priority for about 7 minutes per typical day on ONE at-the-money APPL equity option. That is, after about 7 minutes of trading, you likely would have made 390 order changes on just one equity option (price/qty) just keep the appropriate priority.

So, this prompts the question: what is the probability that you will actually get fills using the priority advantage that the ISE suggested was taking place in 2009 in today's marketplace?

1) The probability of an AAPL, at the money, equity option actually trading on the bid/ask in any "seven-minute period" in a recent period was about 1 in 4. So, every four days you would have a **<u>chance</u>** at getting a fill
2) The fact that close to 100% of orders that sell/buy on the bid/ask are retail customer orders and about 75% of all these customer orders are "paid for" by high frequency traders, results in a 25% chance that one of these orders might trade against your customer priority order (1 in 4)
3) Given market fragmentation (i.e. 16 option exchanges), the probability of you getting a fill will also depend on whether you are posting your "priority" markets on the same Exchange that the opposite order appears (about 1 in 16)
4) The fact that all the option exchanges have Price Improvement rules that allow market makers the ability to step up, in increments of 1 cent, will also decrease your fill rate. Timing/technical issues make it nearly impossible for retail customers to add liquidity during a price improvement auction. Since many brokers/exchanges claim that 90% of all "marketable orders" sent receive price improvement, this means that the probability of gaining priority would be about 1 in 10 (10%)

So, you could in theory post a bid/ask continuously in the market on ONE equity option for about seven minutes before you hit the 390 mark and as long as an opposite order, which would happen every four days isn't "paid for", the order appears on the same Exchange where your orders are located and no Price Improvement auction takes place will you reap the benefits of customer priority. The odds are about 1 in 2,560. Therefore, the "continuous updating pricing models" that the option exchanges were afraid of in 2009 will result today in about ONE fill every 2,560 trading days or about 1 fill every 10 years. In 2021, you could increase the order count ten-fold (from 390 to 3,900) and still no sophisticated retail investor would create a trading model for "priority advantages" that the ISE suggested was **<u>THE</u>** reason for the introduction of this rule.

The reasons outlined by the Option Exchanges for creating this Professional Customer status in the Options market simply don't exist today, so why don't the Option Exchanges change or eliminate the rule?

<u>Answer:</u> The Exchange's **preferred customers** (HFT's) want them to keep this rule. This rule allows the HFT's to distinguish between sophisticated and unsophisticated order flow. The HFT's not only buy unsophisticated order flow from the "Free Commission Brokers" but they also now have everyone else marking their customer option orders as "Pro" or "Reg". They also want Exchanges to create rules that pool the type of order flow they would prefer to trade against. This is done by not allowing "Professional" customers to participate in things like Price Improvement auctions in the Complex Order Options Market and this is precisely what the IEX is proposing by Excluding the Professional Customers from their Mid Market Equity Auctions.

In fact, many Market Makers and secondary liquidity providers have been driven from the marketplace because of the rules that allow the HFT's the ability to trade against virtually all the regular customer order flow.[1]

Twenty years ago, no one in this industry would ever admit to purposely creating a two-tiered market (one for sophisticated and one for regular investors) simply to benefit themselves. Exchanges are not supposed to operate like **casinos**. They are not supposed to cater to **preferred customers**. Anonymity is an important aspect of an efficient and fair market. Today, the IEX wants to create this two-tiered model when there is NO reason to disadvantage large equity investors. They are not denying it. Here it is in their own words:

IEX believes that limiting the pool of customers eligible to enter Retail orders, as proposed, will incentivize additional resting liquidity seeking to trade against such Retail orders (and provide price improvement) because of their nonprofessional characteristics.

This approach was supported by Citadel Securities in a comment letter on EDGX's retail priority proposal. Citadel Securities notes that "[t]he market's experience with [retail programs] evidences the failure of an overly broad definition of 'Retail Order'. [Retail programs] have not gained traction in the market, precisely because the [retail programs'] definition of 'Retail Order' includes orders from both retail investors as well as active professional traders. To the extent that the 'Retail Order' flow routed to [retail programs] includes orders from active professional traders and is thus not as attractive to other market participants, those market participants will simply elect not to post [retail] liquidity and fill-rates for [retail] routes will be low." See Letter dated April 26, 2019 from Stephen John Berger, Citadel, to Eduardo A. Aleman, Commission.

The Options market at least had a reason in 2009. Although the same reason doesn't exist today, they at least had a reason. The rationale for a similar rule in the equity market is simply for the IEX to appease the high frequency traders which will also benefit themselves. They want to pool all the unsophisticated orders together so the HFT's can "safely" trade against them. I don't see much of a difference between this and **Payment for Order Flow**. Many on Wall Street frown upon the "Free Commission Brokers" because they pool unsophisticated customer order flow and sell it to the HFT's. The amount they pay for this order flow depends on what they believe the **sophistication level** is of the brokers respective customer base. The IEX is essentially saying the same thing – "hey Citadel, participate in our auctions: it's safe to trade here (i.e. no more professional customers)".

To be fair, the IEX will tell you that many retail investors will benefit because the "increased" liquidity provided by HFT's will result in better prices. I believe this benefit (if there actually is a benefit) will be short lived. Of course, the HFT's will also tell you how they provide great fills via their respective **Payment For Order Flow** programs. HFT's will claim that the fills they provide via these programs are "fair" because they are filled at prices better than the NBBO. This is similar to saying that you got a "fair" price buying a new car if you save $50 off the car's MSRP. The point is, the quality of a fill should be based on all liquidity in the market (including the hidden liquidity) not just the posted liquidity which clearly is lacking as a result of the current Market Structure.

Similar to the options rule in 2009, this IEX rule likely won't harm too many in the short term but it does open up the possibilities for similar rules that would have negative consequences to liquidity in the equity market longer term. Once this rule is approved, you can expect the big two Equity Exchanges to follow up with similar rules.

[1] In March of 2017, the CEO of an Options Market Making firm announced that they would cease their Options Market Making business after 30+ years of doing so. Here is a quote from the press release: ""Having initiated the first automated option market making operation in the mid '80s, which grew into the largest such business on a global scale over the next 25 years, it's been painful for me to see it deteriorating in the last few years. But we do not have a choice in this matter. Today retail order-flow is purchased by large order internalizers and joining them would represent a conflict we do not wish to have. On the other hand, providing liquidity to sophisticated, professional synthesizers of short-term fundamental, technical and big data is not a profitable activity.

Perhaps they will charge higher fees for these "Professional Customers" (as many of the option exchanges do) and look for all these Equity Exchanges to sell new "**proprietary data feeds**" that only the HFT's will buy so they can discern the sophisticated/professional investors. CBOE EDGX (options) did just this in 2019 (SR-EDGX-2019-012). Here is a quote from Citadel's comment letter (April 26, 2019) suggesting the equity market take the same approach as the options market:

We recommend that the Commission explore criteria that would be most useful in distinguishing professional customers from retail customers in the equity markets for the purpose of the Proposal and any other similar mechanisms that may be proposed in the future.

Consequences of Two-Tiered Markets

Today the option market has seen average bid-ask spreads increase to about $3 per option contract from under $1 in 2009[2]. Given the 390-order rule, and the fact that there is **hidden liquidity** in all markets (equity and equity option), how is an Investor supposed to get the best possible price today? For example: Let's say a posted market has a $3 spread ($15 bid $18 ask). Depending on the minimum tick, there could be as many as 300 price points between the bid and ask. It is important to note that the real market is significantly better if you include the **hidden liquidity**. This "real" market (including all liquidity), might in this example have a $.60 spread, as it was in 2009 (i.e. $16.20 bid $16.80 ask). A HFT might fill a customer buy order at $17.99 and because the price is better than the **posted** offer ($18), they will have everyone believe that it is a fair price even though they essentially traded through the best offer. Therefore, the only true way to get the **best** price (buying) would be to bid $15.01 and increase your bid by .01 until you find that **hidden liquidity**. You should NOT start at the mid price ($16.50) as you may trade through the best hidden offer. Given there are currently about 300 price points between the bid and ask for the **average** equity option, you can see how easy it would be to get above 390 orders in a day when all you are doing is trying to get the possible price. Here is a little test that the SEC can do: Find an option with a large spread as in my example. Place a limit order to buy 1 contract at $15.30 (slightly better than the posted bid) and watch all the HFT's join you on the bid with 100's of contracts. Repeat the process. The current market structure in the options market does not reward **posted** liquidity because of Price Improvement Rules and the 390 rule limits how many orders a "secondary" liquidity provider will display, limiting overall competition. HFT's love the current market structure. There is no incentive for them to display their best price thus you get larger bid/ask spreads. Why sell at $16.80 (their "real" best offer) when you can sell at $17.99 and claim a fair price?

Investors like myself will often sacrifice price for order count. That is, I will knowingly pay a "likely" higher price for an option just to save on the number of orders I send. I would argue that there is no such thing as "best execution" for retail customers in the equity options market today because of the 390-order rule. **You are asking all investors to sacrifice "best execution" over customer status**.

Speaking from experience, I can tell you that my fill rate decreases dramatically once I am designated a "Professional Customer" in the Options Market. That is, your orders are often ignored when they are marked as "professional". The "fill rate" on my orders (when simply looking for what I believe is a fair price) has gone down

---

[2] October 6th, 2009, the day the ISE introduced their rule, there were 321,144 equity options listed. The average bid/ask spread in the options market at that time was a mere $0.60. On April 30, 2021, there were a total of 1,388,302 Equity Options trading and the average bid/ask spread has increased to $2.92.

on average by about 60% when my status has changed to that of a "professional" customer.[3] This is why Investors **will** make the sacrifice mentioned above.

The simple way to analyze a rule like this is to estimate what the consequences will be with respect to liquidity in the marketplace. The Options rule has definitely reduced liquidity because the industry has accepted that retail traders that enter greater than 390 orders per day should face the following consequences:

1) Have their orders excluded from some auctions (similar to the what the IEX proposes)
2) Increase their respective fees. These traders are sending so many orders to the Exchanges that they respond by actually **raising** their per contract fees. It's as if they don't want their business. Not many businesses on this planet (if any) would actually increase per unit fees for a customer as a result of increased business with that customer. Ironically, these same Exchanges offer higher rebates/lower fees to Broker Dealers if they hit certain monthly/quarterly volume thresholds.
3) Have their orders marked differently than smaller retail customers, leading the Exchanges to profit from selling proprietary feeds that allow the larger more sophisticated order flow to be discriminated against.

These three consequences will certainly reduce the liquidity in the market. This reduced liquidity results in higher bid-ask spreads.

The biggest complaint by long term investors in the Equity Options market today is the large spreads and lack of market depth. Well, when you cater to a **"preferred customer"** and have rules that punish those who provide liquidity……what do you expect?

Conclusion

I believe there is a high probability that large long term equity investors will be negatively affected by the string of rules that are likely to come in the short run if you approve this rule and **all investors** will be negatively affected in the long run as bid/ask spreads are likely to increase for equities the same way they have in the Options Marketplace. The consequences of this rule are not what happens today or tomorrow but what will likely happen 5-10 years down the road. In 2003, I wrote to the commission regarding "possible higher option" bid-ask spreads and my concerns were ignored.[4]

It doesn't matter whether we are talking about the HFT's, Broker Dealers or the Exchanges. They are all typically complicit with these types of rules because they all find ways to benefit from them at the expense of the long-term investor. The SEC should take a longer-term approach when deeming the viability of this rule. This long-

[3] My monthly volume in the Options market fell by 58% in the 3rd quarter of 2020 when I was designated a "Professional". This is compared to the 2nd and 4th quarters of 2020 when I was designated a Regular Customer even though I was entering about the same number and same type of orders. As a Professional you could actually see other regular customers getting fills that you can't get because your orders are ignored.

[4] Letter to the SEC Dated: February 3rd, 2003. "if outside liquidity providers are constantly being shut out, then one should expect that they will likely be driven from the marketplace creating wider spreads overall making the market worse for everyone including liquidity takers. The bottom line is that, the more **independent** liquidity providers (whether market makers or outside participants) the better the market for all liquidity takers."

term approach is something that regulators should be keenly aware of, as their recent losses in the courts with these same **market participants/exchanges** are often the result of previous rules that they themselves rubber stamped years ago. (i.e. maker/taker fees)

What will the **market participants/exchanges** ask for next? How about a "wb" marking on all of Berkshire Hathaway's orders?

I ask the SEC to not only reject this rule but to look into other existing rules that are primarily designed to identify levels of sophistication in the marketplace. It is time to protect the anonymity of **ALL** orders in **ALL** markets.

Sincerely,

Mike Ianni

Individual Investor