SR-ISE-2006-23 comment

I am a retail broker working for a firm that represents options customers. I would like to comment on how this proposed rule and many similar rules adopted by other options exchanges are not about technological issues, but are about protecting directed order flow and the payment for that order flow and protecting exchange members to the detriment of the public. I respectfully request, in the interest of fairness to the investing public, that this rule be rescinded.

It is common practice at the options exchanges that the specialists, who are members of the exchanges, pay retail firms for order flow. It is obvious that for this system to work, the specialist must be able to make profits on the trades from this order flow that are greater than the payment the specialist makes to the brokerage firms for sending the order flow. The type of business that lends itself to the payment for order flow model are retail market orders that are not changed to respond to changes in the market prices of the underlying securities or indexes. In other words, these are orders that can be executed “at the market” wherever the market may be.

Active options traders watch the market very carefully. When the market for the underlying securities or indexes changes, the active option traders respond to those changes and cancel orders that no longer make economic sense. The active trader has no alternative other than to cancel the orders. There is no way for that trader to modify his order to respond to the changes in the market. The specialist, on the other hand, can just refresh his quotes.

The ISE and other options exchanges have more than adequate technology and available bandwidth to accommodate a huge amount of order flow, more order flow than they have today. The fact that the exchanges have changed their rules to allow for automated order entry demonstrates the ability to accommodate increased electronic order flow.

The customers at my firm range from the inactive traders to the very active traders. Cancellation fees have always been directed at discouraging the activities of active traders. The proposed changes to the manner in which cancellation fees will be determined will cause additional economic damage to those traders, further reducing the competition in the marketplace. The beneficiaries of these changes will be the exchange members.

Our most active customers are being singled out by this rule and all options cancel fee rules for a few simple reasons. The crux of the issue and the reasons for all the rule changes that are designed to chase only the very active customers that can direct their own order routing include the following:

1. Customer directed order flow is not sent to the exchange of the brokers choosing, but to the exchange of the customer’s choice. This is not the preferred “smart routed” flow of the type that lends itself to the payment for order flow system or of the type that lets the specialist participate in more of the profitable trades.
2. Customer directed orders cannot be controlled by the members of the exchanges.
3. Exchange members pay for orders from brokerage firms and need to profit from those trades by directing the orders to themselves at the exchange of their choice.
4. Exchanges profit from executions only when one of their members trade, they do not profit when a customer order happens to trade with another customer order.
5. When a customer directs his own orders to the exchange of his choice the customer may interfere with the exchange members’ ability to trade with the directed flow because more customer orders are trading directly with other customer orders, thereby bypassing the specialist. If a self directed customer order happens to match up with a smart routed customer order that the exchange member has paid for, and then the exchange member has paid for an order from which he did not profit. By getting the active trader out of the way, the exchange member can retain that opportunity for himself.
6. ISE says they won't charge for order cancellations that improve the bid or ask. What the ISE doesn't explain is that they will charge for cancellations of orders that improve the

liquidity of a series by matching a bid or offer because such liquidity may interfere with the specialist's opportunity to profit as explained above. These actions violate the public investor's right to participate in a free and open market. The exchanges are supposed to be encouraging liquidity, not discouraging it.

These are the real reasons behind exchange cancel fees. The exchange members are telling their boards of directors to get rid of the active direct access customers. The exchanges are now earning revenue streams from cancel fees. The cancel fees are the only deterrent they have been able to create to slow down or discourage trading by the active customer. The assertion that the reason underlying the cancel fees is based on technological concerns is simply false.

The ISE and other exchanges have audited my customers' trade data and records for at least five straight quarters in an attempt to find rule violations committed by my customers and to learn about the identity of my customers by requiring the submission of customer new account forms. This contradicts a basic principle of fairness that depends on the anonymity of electronic trading. Despite these investigations, there have been no violations found. As a result the ISE has decided to modify its cancel fee policy by aggregating multiple orders within thirty seconds and marking the orders to the clearing firm level. This just strengthens the assault on active traders. These regulatory changes are not about technology; these actions are merely attempts to stop active direct access customers. Furthermore, the ISE is now proposing in SR-ISE-2006-26 to reclassify customers that may trade more than 100 times a day as professional customers, creating a new level of customer that will be charged the same fees as specialists without having the other economic advantages that specialists have, and will be denied the priority historically given to a public (non-broker-dealer) customer. When trading options in an active stock like Google, a customer must constantly enter and change orders and the only way to change orders is to cancel them. By "taxing" a customer for making changes to orders in a stock like Google, the exchange will reduce liquidity and impede competition. Again, the only beneficiaries will be the exchange members. The public will suffer.

The first cancel fees were calculated and charged by executing broker, and then later calculated and charged by executing CMTA number. My firm maintains relationships with multiple executing firms in order to keep anonymity and we are penalized because the ISE charges each one for its own cancel and fill ratios. Now in an attempt to destroy my customers' anonymity, the ISE has refined the rule to calculate and charge the cancellation fees at the clearing firm level. This just isolates my customers and will force my firm to align with whichever clearing firm has the best fill to cancel ratios. In another bold and highly controversial move the ISE has proposed aggregating all orders in the same security at the same price within a thirty second period as one order. Do they propose that all orders from our clearing firm will be from the same customer? If they are allowed to aggregate all fills within thirty seconds they should also be required to aggregate all cancels within 30 seconds. At least this would achieve some sort of parity. The next step the exchange will take will be to force us to identify the names of each customer and prove to them that they are different. To make matters worse, the ISE does not bill the executing broker; the ISE just takes the money from the clearing member's account and forces the broker to prove that the deduction was wrong.

The ISE is well below its maximum capacity to handle order flow and has imposed a tax on active customers direct access in an attempt to drive away those customers to benefit its members. If this measure does not work, the ISE will keep proposing new rules until it finds something that does. These repeated attacks on an open market and competition in the marketplace should be stopped.

Thank you,

Paul Mishkin