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SEC's Latest Market Structure Initiative: Proposed Limitation on Options Market Access Fees

Introduction

In an action that potentially affects the business models of the U.S. options exchanges and major option market participants, the Securities and Exchange Commission (the "SEC") recently issued a proposal that would cap exchange "access fees" for listed options and also prohibit exchanges from imposing unfairly discriminatory terms that inhibit access to quotations in listed options.[1] These proposals would extend to listed options two provisions of Regulation NMS that currently apply only to listed stocks.

If the proposal is adopted, it may yield a number of options market structure benefits, including: limiting the extent to which exchange fees cause actual execution costs for listed options to differ from the exchanges' published quotations; rationalizing the operation of inter-market "trade through" requirements; reducing the practical issues with banning "flash orders" in the options market, as proposed by the SEC; and preventing an exchange from imposing unreasonably discriminatory fees on nonmembers seeking indirect access to the exchange's published quotations through a member. However, the proposal would diminish the effectiveness of a common market model (a "Maker/Taker Model"), in which some exchanges attract aggressively priced limit orders by paying rebates for posting quotations that are ultimately executed against, and finance those rebates through access fees. Ironically, this likely would encourage markets to compete for customer orders through exchange-sponsored payment for order flow programs, which many have criticized on public policy grounds.

Access Fees

The SEC proposes to amend Rule 610(c) of Regulation NMS to prohibit any 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 on an aggregate basis more than $0.30 per contract (which is equivalent to the $0.003 per share access fee cap applicable to most listed stocks under Regulation NMS). This limit applies across the board, including to low priced options.

The fee cap would apply to "take" fees under a Maker/Taker Model, licensing fees, options regulatory fees and other transaction-based fees charged upon executions against the exchange's published quotations. However, the cap would not apply to fees imposed on trades other than executions against the exchange's displayed quotation,[2] or to fees not triggered by the execution of orders, such as monthly or annual membership fees.

Fees subject to the cap would include not only those charged directly by an exchange, but also fees charged by a market participant, such as a specialist, that displays a quotation through the exchange's facilities. The cap would apply on an aggregate basis to fees charged by both the exchange and the market participant.

[1] Exchange Act Release No. 61902 (April 14, 2010).

[2] The proposing release provides technical guidance for exchanges that choose to apply access fees in excess of the cap for those executions that were not subject in whole or in part to the cap, and also for situations where orders interact against nondisplayed orders with superior prices to the exchange's displayed quotation.

One significant aim of the proposal is to rationalize the relationship between the exchanges' best priced quotations and the all-in transaction execution cost (which includes exchange transaction fees). This is important because exchanges must institute procedures to ensure that they do not execute orders where there is a better displayed price at another exchange (referred to as a "trade through"). To avoid trading through, an exchange must either cancel an order that could be executed at a better price at such other market or "route" the order to such market, unless an exchange member "steps up" to trade at the better price displayed by the other exchange. Because exchange access fees are not included in the published quotation, some orders may be routed to another market even though, when the other market's fees are taken into account, the overall cost of execution is inferior to that on the market to which the order was sent in the first place.

At a high level, the SEC sees the potential for unfettered access fees as unduly inhibiting access to exchange quotations, obscuring the transparency of the marketplace, enabling exchanges to charge high fees selectively for competitive reasons and undermining the inter-market price protections provided by the trade through/order protection requirements. These concerns motivated the SEC to limit such fees for listed stocks when it adopted Regulation NMS.

The disparity between actual execution cost and best priced quotations that results from unlimited exchange access fees, coupled with the complexity and diversity of exchange fee schedules, may result in an incentive for options markets to permit their members to use "flash orders." Flash orders are orders that remain in force for only a fraction of a second before being cancelled or routed away. They effectively enable an exchange member to "invite" other market participants to improve their quoted price in order to match a better price displayed at another exchange, thereby resulting in an execution on the exchange and preventing the order from being cancelled or routed to the other market. The SEC has proposed[3] to ban flash orders for both listed stocks and options, but has not yet acted on that proposal – possibly due to concerns expressed about implications for the options market.

A further aspect of the proposal that bears on market practices and competition in the options market pertains to exchange-sponsored payment for order flow programs, which have been adopted by markets that do not operate under a Maker/Taker Model. The proposing release states that the fee cap would not generally apply to payment for order flow fees because these exchange fees do not directly impact the ability of a market participant to access an exchange's best priced displayed quotations. This may have the result of enhancing the attractiveness of exchange-sponsored payment for order flow over a Maker/Taker Model as a means of attracting business. Many have criticized exchange-sponsored payment for order flow programs as potentially resulting in wider spreads than would otherwise prevail, favoring specialists (and similar market participants who administer these programs) and undercutting incentives to obtain best execution.

Not only would the fee cap aspect of the proposal potentially reduce the fees charged by exchanges that have Maker/Taker Models and likely lead them to reevaluate the relative merits of that model versus exchange-sponsored payment for order flow, but any significant changes by exchanges in this regard could have significant revenue impacts and strategic implications for exchange market makers and firms that route orders to exchanges.

One curious aspect of the proposal is that, despite the SEC's principal stated objective of buttressing inter-market linkages and trade through protection, the proposal would apply the fee cap to products, such as certain index options, that trade only on a single market. The release requests comment on this issue.

[3] Exchange Act Release No. 60684 (September 18, 2009).

Anti-Discrimination Rule

The SEC also proposes to extend to the listed options market Rule 610(a) of Regulation NMS, which prohibits exchanges from imposing unfairly discriminatory terms that prevent or inhibit indirect access to the exchange's quotations in NMS stocks by nonmembers. While the proposed amendment of Rule 610(a) would not be limited to exchange fees, its most obvious impact would be to prohibit an options exchange from charging "differential fees based solely on the nonmember status of a person obtaining indirect access to its quotations."

Rule 610(a) is intended to allow nonmembers of an exchange to obtain access to the exchange by "piggybacking" on the access and volume discounts available to an exchange member. Such indirect access is viewed as an important safeguard to the ability of nonmembers to fulfill their duty of best execution and comply with the trade through rule.

The proposing release states that nondiscriminatory access does not require free access, nor does the nondiscrimination standard apply to other services that markets generally provide only to their members (though other fair access provisions and statutory provisions governing rules of self-regulatory organizations will apply).

Due to the use of the term "quotation" in Rule 610(a) – defined to include all bids and offers – the proposed rule would apply to the depth of book of listed options orders.

The proposing release states that it is the SEC's preliminary view that it would violate the proposed standard if an exchange charged an options market maker from another exchange a higher fee for obtaining access to its quotations than the fee charged to both member and nonmember broker-dealers that are not market makers on that exchange.

Conclusion

The proposal received unanimous support from the SEC's Commissioners, though certain Commissioners expressed interest in receiving comments on, among other things, the proposal's likely effect on competition among exchanges and the appropriateness of the proposed fee cap level. The proposing release requests comments on these and numerous other aspects of the operation and mechanics of the proposal, and also whether there are alternative means of achieving the Commission's stated policy objectives. It appears that the Commission would be particularly interested in receiving comments that address the differences between the equity and listed options markets and whether such differences justify different standards.

The comment period for the proposal is 60 days from the date of its publication in the Federal Register.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

Annette L. Nazareth	202 962 7075	annette.nazareth@davispolk.com
Lanny A. Schwartz	212 450 4174	lanny.schwartz@davispolk.com
Gerard Citera	212 450 4881	gerard.citera@davispolk.com
Robert L.D. Colby	202 962 7121	robert.colby@davispolk.com