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September 8, 2008

Via Electronic Mail

Florence Harmon, Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: ***File No. SR-NYSEArca-2008-75; Comments on Proposed Rule Change by NYSE Arca Amending its Schedule of Fees; and***

File No. 4-562; Comments on Petition of Citadel Investment Group to Cap "Take Liquidity" Fees on Options Markets (File No. 4-562); and

Petition for Rulemaking to Apply Any Cap on "Take Liquidity" Fees Equally in the Same Amount to Any Payment for Order Flow Arrangements between Market Makers (and their Affiliates) and Agency Brokerage Firms

Dear Ms. Harmon:

Interactive Brokers Group LLC, on behalf of its subsidiaries Interactive Brokers LLC and Timber Hill LLC[1], submits this comment letter regarding the above-referenced proposed rule change filed by NYSE Arca to raise its Take Liquidity fee in certain issues, and a related petition filed by Citadel Investment Group ("Citadel") to cap "Take Liquidity" fees on U.S. option markets.

We believe that NYSE Arca has the right to alter its fee schedule as set forth in the proposed rule and we oppose any Take Liquidity fee cap lower than 99 cents for an option contract quoted in pennies. *In addition, if the Commission does impose a cap on Take Liquidity fees, we petition the Commission for rulemaking to impose a cap, at the exact same level, on private payment for order flow arrangements between market makers (and their affiliates) and agency brokerage firms.*

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[1] Interactive Brokers LLC ("IB") is a direct-access brokerage firm that provides a best execution Smart Routing system for executing customer option orders, along with other investment products. Timber Hill LLC is an options market maker. Interactive Brokers and Timber Hill are members of all seven U.S. option exchanges. Through an affiliate, Interactive Brokers Group owns a significant minority stake in the Boston Options Exchange Group, LLC.

Overview

Even in the current U.S. options market where many contracts are quoted in pennies, the pricing mechanism for options is not completely efficient. Indeed, the minimum penny tick is actually a $1.00 tick per contract, given that a single standardized U.S. option contract covers 100 shares of the underlying stock. The fact that option trades routinely occur at prices somewhat away from fair market value is reflected by the fact that market makers are willing to pay as much as $1.00 to certain retail brokerages for the opportunity to capture and try to trade against those brokers' customer orders.

In this Payment for Order Flow model on the traditional exchanges, the economic incentives are for market makers to quote in lockstep a relatively wide National Best Bid and Offer ("NBBO") and then use a portion of the resulting profits to make order flow payments to brokerage houses with retail order flow. Because there is no price/time priority across exchanges, order flow is apportioned between the traditional exchanges not so much by aggressive quoting (which is not especially rewarded), but by payment for order flow deals. The major market makers try to ensure that they have enough option classes across the traditional exchanges so that they can direct their purchased order flow to execute on whatever exchange will give them the highest allocation of the resulting trade. Retail brokerages (for the most part) are happy to accept the order flow payments, add them to their bottom lines, and then point out that their customers' orders – *ipso facto* -- are being traded at the "national best price".

Payment for order flow reduces competition in the options market. Market making firms that pay retail brokerage firms for their customers' orders guarantee that those orders will be executed at the NBBO, and they do this by stepping up and matching better prices that are posted elsewhere. Thus, a market participant posting a better price often will not get to trade on that price because a bigger player with purchased order flow can simply match the better price and trade against any customer order seeking that better price. In the short term, matching better prices posted by someone else raises the cost of servicing the order flow for the market maker that has purchased it, but in the long run, other market participants learn that narrowing the quote does not lead them to trade more often. Market participants that are not in the payment for order flow game lose the incentive to quote aggressively since so much retail order flow is bought and paid for and beyond effective competition.[2]

Maker/Taker exchanges have attempted to change the incentive structure to reward aggressive quoting by market makers, non-market maker broker-dealers, and customers. Maker/Taker exchanges charge a transaction fee – a Take Liquidity fee – to a market or marketable limit order that takes liquidity from their books and then they pass a percentage of that fee –in the form of a "Make Liquidity" rebate -- to the trader that posted the limit order that was traded against. Maker/Taker exchanges try to reward traders that post aggressively-priced limit orders because those traders receive the Make Liquidity rebate. And Maker/Taker

[2] Payment for order flow deals also reduce competition because of the "lock-in" phenomenon. When a retail brokerage firm enters into a payment for order flow arrangement with a market making firm, there is significant overhead such as technology integration work and contractual and other legal and compliance work to effectuate and document the arrangement. Once the static order routing relationship is established, it can be costly and technologically difficult for the retail brokerage firm to change the relationship.

exchanges "democratize" the market structure by rewarding anyone – market maker, broker dealer or public customer – that provides liquidity.

The Maker/Taker model, which rewards aggressive options pricing, also raises the costs and harms the profits of the major players that have aggressively purchased order flow. This is because these firms often must match the better prices posted on Maker/Taker exchanges (*i.e.*, they are forced to trade at prices more favorable to customers) and yet still suffer the fixed costs of having to pay retail brokerage firms for their order flow.

The traditional exchanges, the lead market makers who have invested in option classes on those exchanges, and the retail brokerage firms that receive payment for order flow, therefore all have a significant interest and investment in the Payment for Order Flow model (and face a significant threat from the Maker/Taker model). Although clothed in the language of the public interest, Citadel's petition for a Commission-imposed cap on Take Liquidity fees is an attempt to strangle the Maker/Taker exchanges in their cribs by limiting the Take Liquidity fees that these exchanges can charge and therefore limiting the Make Liquidity rebates that these exchanges can pay to liquidity providers that narrow the NBBO.[3]

If the gambit embodied in the petition is successful, the proponents of the Payment for Order Flow model will have accomplished two important goals – limiting the structural incentive that market participants have to narrow the NBBO, and limiting the types of competitors that have an incentive to quote aggressively (*i.e.*, customers, non-market maker broker dealers, and market makers that do not pay for order flow).

While the petition attempts to hamstring the Maker/Taker exchanges by subjecting them to an arbitrary cap on the Take Liquidity fees that they may charge, the petition is deafeningly silent regarding private payment for order flow arrangements, which would remain completely un-capped, unlimited, unfettered, un-interfered with, and off the books.

Simply stated: Alternative market structures such as Maker/Taker models and Price Improvement mechanisms resolve the pricing inefficiency in the options markets by providing better execution prices for customers. The Payment for Order flow model resolves the inefficiency through large payments to brokerage firms for their customers' orders.

It would be ironic and poor public policy for the Commission to place a limit on the transparent, publicly-disclosed, equally-applied and disseminated Take Liquidity fees that can be charged by Maker/Taker exchanges (and that support the Make Liquidity rebates that these exchanges pay) while at the same time placing no such limits on the non-transparent, unequal and largely undisclosed payments for order flow that are made by market makers and their affiliates to retail brokerage houses to capture their order flow. This "See No Evil, Hear No Evil" form of policymaking urged by the petition will have the predictable and depressing effect of enshrining the Payment for Order flow model on U.S. option markets for the foreseeable

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[3] The petition claims that it is only intended to limit Take Liquidity fees and does not address Make Liquidity rebates. However, capping Take Liquidity fees would have the direct effect of capping Make Liquidity rebates, as the rebates paid to liquidity Makers are funded directly by the fees paid by liquidity Takers.

future, while keeping the actual payment for order flow practices that support the model safely unregulated, under-wraps and beyond meaningful review or scrutiny by the Commission, customers or the public.[4]

Discussion

- ***Even assuming that a broker passes through and charges to its customer the full amount of the Take Liquidity fee, if the fee is 99 cents or less per contract, the customer is better off paying the fee and receiving a $1.00 better price (the one penny tick equivalent) on a Maker/Taker exchange.***

The argument that Take Liquidity fees should be capped is based almost entirely on the (correct) observation that if an away Maker/Taker exchange is displaying a *better* price than a traditional Payment for Order Flow exchange, the intermarket linkage trade-through rule in options requires that the customer order be routed to the away market, at which time the Take Liquidity fee will apply (where the away Maker/Taker market is merely displaying the *same* price as another market, the order is *not* required to be routed because there is no time priority across U.S. options markets).

The petition tries to dress up this central point by claiming that Take Fees "distort" the market and disparately impact "retail" investors, but these and other subjective characterizations are a red herring. <u>It is a question of straightforward mathematics:</u> If a customer order is getting a one penny better price on a Maker/Taker exchange (equivalent to $1.00 per contract), the customer is better off if the customer's order is routed to the Maker/Taker exchange, as long as the Take Liquidity fee is 99 cents or less.

We agree with the petition that a per-contract Take Liquidity fee that is greater than the per-contract tick equivalent (*i.e.*, a fee greater than $1.00 for a contract trading in pennies) *would* distort the market, because in such case the customer would be *worse* off routing their order to the better-priced market and paying the Take Liquidity fee.[5]

But as long as the customer comes out ahead overall by getting the better price on a Maker/Taker exchange and paying the Take Liquidity fee (as the customer would with any fee of 99 cents or under), the arguments in the petition are strictly a matter of smoke and mirrors.

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[4] Published rules do exist on traditional exchanges regarding marketing fees that are collected from market makers in the crowd and paid to lead market makers. But exchange rules do not address and do not require approval or complete disclosure of the payment for order flow arrangements that the lead market makers and their affiliates then strike with agency brokerage firms.

[5] We have no objection to a $1.00 or greater cap on Take Liquidity fees for contracts quoted in pennies.

- ***Make Liquidity rebates, which are financed by Take Liquidity fees, encourage aggressive quoting and narrowing of the NBBO, as market makers (and customers and also other broker-dealers) post better prices to try to receive Make Liquidity rebates. As other exchanges match these better prices, the entire market benefits.***

An arbitrary Take Liquidity fee cap (*i.e.*, any cap under 99 cents for a penny option) will reduce the incentive to narrow the NBBO and also reduce the parties that have such an incentive. What Citadel and others really want (as evidenced by their relentless opposition to Price Improvement auction models and Maker/Taker models) is a full Payment for Order Flow model in which all exchanges quote in lockstep at a relatively wide NBBO and -- because there is no price/time priority across exchanges -- order flow is directed between exchanges and traded at NBBO largely according to private payment for order flow deals.

- ***Public customers that add liquidity and transparency to the market by posting limit orders are directly eligible to receive Make Liquidity rebates, which brokers like IB directly pass through to customers. On the other hand, payment for order flow seems mostly to stop at brokerage firms' bottom lines, and not quite make it to customers.***

Unlike with private payment for order flow deals, whose exact payment terms and amounts are largely opaque to customers, Take Liquidity fees and Make Liquidity rebates are clearly published and fully transparent to the public. Customers can see exactly how much their broker was charged or rebated for an option order on a Maker/Taker exchange and can see exactly how much of these fees and rebates were passed to the customer. Customers can and do compare competing brokers and exchanges and negotiate with their brokers the pass-through of Maker/Taker rebates and fees.

While they had been mostly locked out of the payment for order flow game, upon the advent of Maker/Taker market models, well-informed customers quickly realized that they could reap the benefits of Make Liquidity rebates by placing aggressive limit orders in the market. Opening the market up to these traders increases competition, narrows spreads and adds transparency and liquidity for smaller public customers.

- ***Likewise, broker dealers that are not registered market makers are eligible to receive Make Liquidity rebates and thus also have a strong incentive to contribute to price-setting and narrowing the NBBO on Maker/Taker exchanges.***

By contrast, on traditional payment for order flow exchanges, non-market maker broker dealers benefit mostly by selling their order flow to market makers and not by aggressively quoting for their proprietary accounts.

- ***If the Commission is concerned about crossed markets, exchanges could be prohibited from charging Take Liquidity or other transaction fees on orders received from an away exchange if the executing exchange had posted a quote that crossed that away exchange.***

It is not clear that locked markets or crossed markets (*i.e.*, zero or negative spread conditions) are harmful to customers. Locked markets present an opportunity for customers to trade without paying a spread and crossed markets represent an arbitrage opportunity for customers. In any event, a concern over the relatively minor issue of locked and crossed markets cannot justify imposing an arbitrary fee cap on the vast majority of orders that do not involve locked/crossed markets.

Exchange rules already prohibit an exchange from posting a quote that locks or crosses another exchange, requiring the locking or crossing market maker to take their quote down or direct an order through the intermarket linkage. If the Commission feels that current rules are not sufficient, it can address the issue of Take Liquidity fees in locked/crossed markets very narrowly – by simply preventing exchanges from charging Take Liquidity or other transaction fees on orders received from an away exchange if the executing exchange had posted a quote that crossed that away exchange.

<u>Petition for Rulemaking to Apply Any Cap on "Take Liquidity" Fees Equally in the Same Amount to Any Payment for Order Flow Arrangements between Market Makers (and their Affiliates) and Agency Brokerage Firms</u>

Citadel's petition is of a piece with other recent moves by the proponents of payment for order flow to try to use institutions like the Commission and the SIFMA Options Committee to pass rules and initiatives that would ensconce the Payment for Order Flow model and cripple competing market structures like Maker/Taker models or Price Improvement auction models.[6]

As outlined above, customers still benefit (directly and indirectly) when they get a better price on a Maker/Taker exchange even if they pay a Take Liquidity fee of up to 99 cents. Therefore any cap on Take Liquidity fees that is set at under 99 cents would be an arbitrary imposition on the Maker/Taker exchanges' economic model compared to the Payment for Order Flow model of traditional exchanges.

If the Commission does, however, decide to impose a cap on Take Liquidity fees, it is critically important that it impose exactly the same cap on private payment for order flow arrangements between market makers (and their affiliates) and agency brokerage firms. As discussed at length above, the Payment for Order Flow model reduces price competition and aggressive quoting, since firms that have purchased order flow simply match better prices posted by other market participants and trade against eligible orders themselves. Payment for Order Flow thus leads to a relatively wider NBBO with a few major players competing for orders not through quoting but through the amount that they are willing to pay retail brokerages to capture

[6] The recent industry initiative to publish best execution data for options on a voluntary basis is a prime example of this. The proponents of the Payment for Order Flow model initially resisted including statistics about orders receiving price improvement through auctions like the BOX Price Improvement Period or ISE Price Improvement Mechanism. Finally, a compromise was reached under which price-improved orders are to be included, but only in a separate section, and with a "Surgeon General's Warning" that seems aimed only at confusing customers and convincing them that price improvement of their orders is somehow bad for them.

their order flow. Customers see worse prices for their option orders, and liquidity providers who do not have payment for order flow programs are left out of the game.

It would be truly unfortunate for the Commission to impose a static, centrally-determined fee and rebate structure on the Maker/Taker exchanges while turning its head and leaving unrestricted and un-regulated the anti-competitive payment for order flow arrangements that dictate how orders are allocated between the traditional exchanges. We therefore petition that if the Commission engages in rate-making that limits the fees charged (and rebates paid) on the Maker/Taker exchanges, it apply the exact same rate limitations to the order flow payments made by market makers to agency brokers that govern how orders are directed to the traditional exchanges.

Respectfully submitted,

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