

International Securities Exchange  
Position Paper on

# Flash Orders in the U.S. Options Markets

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## Background

In late July 2009, Senator Charles Schumer asked SEC Chairman Mary Schapiro to ban the “flash orders” that are offered by some exchanges. Senator Schumer and other critics of flash orders assert that these orders create a two-tier market structure that disadvantages investors who submit orders that are subsequently flashed by allowing a select group of high-frequency traders to “look” at the order and then trade ahead of it on another market. The arguments then claim that the investor submitting the order may subsequently receive a worse price than if the order had simply been routed immediately to the exchange with the better price and not flashed to the electronic “crowd” on the original market.

Following the initial attention created by Senator Schumer’s letter, the press, industry analysts, and commentators have engaged in a wide-ranging debate about the benefits and deficits of this functionality, the role of high-frequency traders in the markets, and even the proper industry standards for technology hardware usage through such practices as co-location. Among the issues raised in these discussions, there have also been instances where certain unrelated aspects of market structure have been erroneously linked together.

The purpose of this paper is to: (i) define flash orders; (ii) outline the benefits they provide to investors; (iii) discuss the competitive dynamic behind the debate; and (iv) recommend solutions to the concerns raised about these procedures.

## Definition of Flash Orders

### **What is a flash order?**

Procedures defined by a trading venue (e.g., exchange or ECN) to expose marketable orders that have been submitted to that venue when the national best bid/offer (NBBO) is at an away market. The marketable order is exposed for a pre-defined period of time and may execute on the original market if responders to the order exposure match or improve the NBBO. If the NBBO is not matched or improved, the order is then routed to the better away market or cancelled back to the order-entry firm (depending on the customer’s original instructions).

## | History of Flash Orders

**Where did flash orders originate?** Flash orders have their roots in floor-based exchanges:

- Manual “flash orders” are a critical aspect of the auction market, where brokers announce orders to a crowd for potential price improvement.
- Electronic markets have also developed flash orders which replicate the auction market process conducted on a floor, but in an automated fashion.
- The SEC has approved flash orders as consistent with the 1934 Act, and there have been no objections raised related to these procedures until recently.

## | Benefits of Flash Orders

**Procedures that offer members the opportunity to step-up and match the NBBO provide benefits to retail and institutional investors:**

- **Sourcing undisplayed liquidity:** Flash orders provide investors with liquidity by tapping into undisplayed trading interest. For example, liquidity providers may rationally determine not to publicly display the full size they are willing to trade at specific price points in today’s rapidly moving electronic markets due to “pick off” concerns.<sup>1</sup> However, these market participants may be willing to provide liquidity when shown a flash order.
- **Providing price improvement:** For any size order, market participants receiving the flash may compete for executions by providing prices that are more favorable than the NBBO. Flash orders also prevent marketable orders from “pinging” between markets, chasing what could be fading prices. Furthermore, in the case of large-size orders, if an order exceeds the size available at the NBBO, rather than “walking the book” to fill a large order at increasingly inferior prices, the flash permits market participants to provide the liquidity to fill the order immediately at a better price.

<sup>1</sup> This term refers to a concern that the market could move so quickly that a liquidity provider may not be able to update his quote quickly enough to avoid an opportunistic professional trader from trading against the still-displayed stale price.

- **Lowering execution costs:** By filling orders on the market of order entry, flash orders allow the order entry firms to avoid potentially significant order-routing fees levied by the away market.
- **Improving execution speed:** Flash orders provide more timely executions by increasing the odds that an execution will occur in the market where the order is entered, without the need to reroute the order. This is critical when time of execution is measured in milliseconds.
- **Encouraging competition and customer service:** Flash orders support competition not only among market participants but also between trading venues, resulting in better customer service, a more efficient market environment and greater customer choice.

#### **Automated flash orders are more fair and efficient than floor-based “flashes”:**

- **Broader dissemination:** Automated flash orders provide the advantage of broader dissemination compared to those on floor-based exchanges where order information is only shared with those members physically present at a trading post or in a crowd.
- **Electronic audit trail:** Automated flash orders also create an electronic audit trail that supports rigorous surveillance procedures.

## **Competitive Dynamic in the Flash Debate**

#### **Exchanges advocating a ban on flash orders have strong competitive incentives to pursue such a ban:**

- **Equity exchanges:** The legacy exchanges have been losing market share to new, innovative markets that have pioneered flash orders. Their call for a ban, while couched in investor protection rhetoric, is a competitive attempt to protect dwindling market share by impeding innovation and the growth of their competitors.

– **Options exchanges:** Maker-taker exchanges (and a small number of their market maker members) are pursuing the flash order ban. These exchanges can sometimes post slightly better prices, especially in options trading in penny increments, because their market makers capture additional revenue by being paid for providing liquidity. Those “taking” the liquidity pay that price. Flash orders permit market participants on exchanges with “traditional” pricing – which typically do not charge fees for most public customer orders – to take liquidity with prices matching those available on maker-taker exchanges. This enables those members to avoid having to pay the taker fees that would be incurred if the order were routed to an away market. In this way, flash orders spare market participants significant expenses by allowing them to achieve superior executions without paying “taker” fees. Banning flash orders would directly benefit the maker-taker exchanges by forcing market participants to pay their taker fees – to the detriment, and at the expense, of market participants (typically firms executing public customer business) who pay those fees.

## | Regulatory Considerations

Flash orders offer numerous benefits to retail and institutional investors as enumerated above. Additionally, they are a fundamental aspect of how ISE and other exchanges compete in the marketplace. Flash orders support customer choice in routing among destinations with different fee structures and market models. The highly competitive dynamic among the options exchanges improves market quality and makes the market more attractive for all investors.

The SEC should properly focus its attention on any regulatory issues raised by flash orders and should seek to avoid any actions that would have purely anticompetitive implications. In this regard, two issues have been identified as regulatory considerations related to flash orders: (i) the potential for front-running and (ii) price priority.

**ISE agrees that front-running is an extremely serious matter.** Even though no evidence exists to point to front-running related to flash orders, ISE recommends the following actions be taken to address these concerns and to provide a basis for preserving the benefits of flash orders while eliminating the possible drawbacks:

- **Broader information dissemination:** The SEC could require that flash order information be available to all market participants, regardless of whether the flash order originates in a floor-based or electronic trading environment. Broader dissemination could include displaying these orders as part of the industry's consolidated market data services, the Options Price Reporting Authority (OPRA), which already has the capability to carry messages other than quotations and trade reports. Making flash orders publicly available eliminates the possibility of front-running since, by definition, a person cannot front run information that is available to the general public.
- **Enhancing surveillance procedures:** Exchanges and the SEC can work together to develop enhanced and coordinated surveillance of the markets to identify potential front-running. Although there have been no indications that there has been front-running of flash orders, pre-emptive action would address the concerns that have been raised publicly and would instill confidence in investors that their orders are safe from front-running while preserving the benefits that flash orders offer to them.
- **Offering flash orders on an optional basis:** To alleviate concerns about the perception of front-running as well as information leakage, trading venues could flash only those orders where investors authorize the flash. Investors could then judge for themselves whether they believe the benefits of possible price improvement outweigh the concern that exposure of their orders could possibly harm the quality of their executions.

**Guaranteeing executions at the best price is a fundamental and critical tenet of the National Market System.** ISE believes that investors should receive an execution at the NBBO or better. However, ISE also believes that markets not displaying the NBBO should have the opportunity to compete to at least match the best price for the following reasons:

- **Price is not the only competitive differentiator:** If competition among markets were limited to price, many other valuable competitive differentiators would be marginalized. In today's market environment, trading venues compete on the basis of customer service, technology, and functionality innovations, in addition to price.

- **Displayed prices are not “all-inclusive”:** In the options markets, a significant fee differential exists between exchanges with traditional pricing and those with maker-taker pricing. Incurring a “take” fee effectively increases the cost of executing an order above the displayed price. Therefore, it should not be assumed that sending an order to a market displaying the NBBO will result in the most economical execution of that order. Providing an exchange that does not charge an execution fee for customer orders with the opportunity to match the NBBO in this instance results in a lower cost execution.
- **Price competition can result in price improvement:** When an exchange initiates a flash auction, participants may choose to respond with a price better than the NBBO. This results in a better execution price than if the order had been immediately routed to another market center. Without flash orders, the opportunity for investors to receive price improvement would be severely diminished.

## Conclusion

Flash orders are similar to orders that long have been in use on floor-based exchanges, and these orders provide benefits to investors. Some critics of these orders are motivated by anticompetitive concerns. However, regulatory action is warranted to address the issue and perception of possible front-running. The SEC should focus its attention on addressing this issue in a manner that preserves flash orders and their numerous, tangible benefits to the market.



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