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SEC Proposes New Investor Protection Measures in the Options Markets

On April 14, 2010, the SEC published for comment a proposal that would extend to the listed options markets additional investor protection measures that currently exist in markets for National Market System ("NMS") stocks. The proposal, if adopted, would:

- prohibit options exchanges from imposing unfairly discriminatory terms that inhibit efficient access to quotations, and
- establish limits on access fees that are charged for access to an exchange's best bid or offer.

Background

Listed options are traded on various registered national options exchanges, and multiple exchanges frequently trade the same options. To ensure inter-market price protection with respect to options traded on multiple exchanges, regulators have adopted certain requirements, including a prohibition against options exchanges "trading through" the best available quotation – that is, executing a trade at a price that is inferior to the best available price on another exchange. Accordingly, an options exchange with a best quotation that is inferior to a quotation at another exchange must either cancel the order, route the order to the exchange with the better price, or otherwise provide for an opportunity to "step up" to a price equal to the best available quotation. In addition, broker-dealers are under a duty of best execution and are generally required to route their customer orders to an exchange with the best quotation.

Market participants, including broker-dealers and exchanges complying with the trade-through rule, access displayed quotations at each options exchange to determine the best quoted price. These exchanges charge fees when incoming orders access their displayed quotations. The amount and types of fees vary among exchanges, and can be substantial. Fees may be applied differently to competitors or depending on the exchange membership status.

The SEC has expressed a concern that current quotations in the options markets may not reflect the actual cost of transactions and that substantial access fees could compromise the trade-through rule and the duty of best execution. Moreover, the SEC believes that different levels of fees could impede fair and efficient access to quotations, which is essential for inter-market price protection.

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In response to these concerns, the SEC proposes to prohibit options exchanges from impeding access to displayed quotations by introducing discriminatory barriers, and to impose a limit on fees that can be charged by the exchanges.

The SEC Proposal

Access to Quotations

Market participants may obtain access to option quotations by becoming a member of an options exchange, or gain indirect access by paying a fee to members of the exchanges (or by "piggybacking" on the members). Currently, however, some exchanges charge additional fees for non-members piggybacking to access quotations.

Under Rule 610(a) of Regulation NMS promulgated under the Securities Exchange Act of 1934, as amended, exchanges are prohibited from adopting unfairly discriminatory terms against non-members who access quotations in any NMS stocks through members of the exchanges. The SEC's proposal would extend this requirement to cover options. The proposal would apply to the entire depth of books of option orders including reserve size and displayed size at each price.

Under the proposal, the exchanges would be prohibited from charging different fees for access to quotations solely based on the non-member status. The proposal is intended to promote indirect access to quotations, which is essential to routing orders to the best quoted prices.

Limits on Fees

Although fees assessed by options exchanges vary in amount and types, the fees are generally triggered by the execution of an incoming order against an order or quotation on the exchange charging the fees. As noted, these fees can be substantial. The SEC believes that if substantial fees are charged in addition to the quoted prices of options and in some cases, selectively to certain categories of market participants, the inter-market price protection mechanism can be compromised as the quotations no longer reflect the true cost of the transactions.

Rule 610(c) imposes a limit on fees imposed on NMS stocks for execution of orders against the best bid or offer in NMS stocks. The proposal would extend this requirement to options. Under the proposal, the fees charged for execution of orders against the best quoted bid or offer on an options exchange could not exceed $0.30 per contract.

As noted, this fee limitation would only apply to fees based on the execution of an incoming order against an options exchange's best bid or offer. Accordingly, the fee limitation would not apply to other fees that are not triggered by execution of orders.

Implications

The SEC has stated that the proposal relating to the options markets is part of its ongoing efforts to ensure that the markets are fair, transparent and efficient. The SEC has separately proposed changes that may affect the ability of exchanges to implement a "flash" functionality to electronically "step up" to match the best price. The SEC believes that the current proposal on limits on fees would eliminate concerns that the separately proposed changes would impede the ability of the options exchanges to efficiently "step up" to the best price for incoming orders.

The SEC believes that options exchanges may modify their fee structures if the proposed rules are adopted. For example, an exchange that currently charges a “Take” fee on access to quotations and in return provides rebate on executed transactions may need to reduce the amount of rebate to offset the reduction in fees. This in turn could affect the order routing and other behaviors of broker-dealers and other customers. Such changes in routing and other behaviors could increase competition among the options exchanges.

Comments

The SEC is seeking comments on all aspects of the proposal. The comments should be received by the SEC on or before June 21, 2010.

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This alert is not intended to provide legal advice, and no legal or business decision should be based on its content. Any questions concerning the issues addressed in this alert may be directed to David S. Huntington ((212) 373-3124), Tong Yu (+81-3-3597-6306) or Akiko Okuma (+81-3-3597-6307).