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Via Electronic Mail

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Release No. 34-64132; File No. SR-BATS-2011-009

Dear Ms. Murphy:

The Chicago Board Options Exchange, Incorporated (“CBOE”) is commenting in response to a proposed rule change submitted by BATS Exchange, Inc. (“BATS”) that would amend its options rules to adopt new procedures for a Directed Order Program (Securities Exchange Act Release No. 64132 (March 28, 2011), 76 FR 18280 (April 1, 2011)(SR-BATS-2011-009). CBOE believes that aspects of the proposal are inconsistent with the Securities Exchange Act of 1934 (“Act”), the rules thereunder, and past SEC approaches to options market structure. As discussed below, we believe the proposal would foster unfair discrimination between option market participants and thwart options market transparency, in clear contravention of the Act. We limit our comments to three points, and we hope BATS is required to respond to each.

1. BATS proposes to only allow BATS market makers to submit non-displayed penny interest in penny classes. CBOE previously adopted rules for a Penny Price Improvement Program that allowed all participants to submit orders in penny increments *in classes that were not trading in pennies*. The idea was to provide all participants with an opportunity to receive penny-plus price improvement even when the improvement did not amount to a full tick better than the displayed quote since OPRA did not handle penny quoting increments at the time. As part of that proposal, the Commission required CBOE to stipulate that users could only submit non-displayed penny prices in classes that were trading in larger minimum increments (\$0.05 or \$0.10 increments). Thus, if a class began trading in pennies, there would be no need for a

program that allowed users to rest secondary non-displayed interest in penny increments. The BATS proposal, however, would allow BATS market makers, and *only* BATS market makers, to submit non-displayed Market Maker Price Improving Orders (“MMPIOs”) in penny increments in classes already trading in pennies (and only for pre-selected directed order participants to trade against those MMPIOs). BATS has failed to explain why hidden penny interest should be permitted in penny classes. BATS has also failed to explain how limiting the entry of non-displayed penny prices to market makers is non-discriminatory vis-à-vis other market participants and is consistent with fair access to quotations. In essence, BATS’s proposal would enable its market makers to establish their own private internalization ATSSs operating through the BATS Exchange.

Allowing BATS market makers to submit hidden interest in the standard trading increment while precluding every other type of participant from doing the same only benefits the BATS market makers and is inconsistent with Section 6(b) of the Act in that it would permit unfair discrimination between customers and dealers. BATS may try to argue that its proposal is no different than participation entitlements that accrue to market makers on other exchanges, but it is actually very different. In instances of market maker participation entitlements, all participants have an opportunity at participating via an auction or via transparent NBBO quotes and order matching rules. For example, if a 10 contract order is auctioned, responders are equipped with the same information to be able to participate in the auction. Similarly, if an order automatically executes against the NBBO quote, participants at that price are aware of where they stand in relation to other participants. With the MMPIO in penny classes, only the BATS market maker would know that it is posting a stealth, non-displayed inside quote that is only available to prescreened order-senders, and it further would know that no other participants can access its interest at that price. To say that other market participants, including public customer orders, can compete under this structure is disingenuous. Moreover, BATS’s assertion that its proposal would encourage quoting at the NBBO is also disingenuous. We believe the proposal would actually create disincentives for other market participants to quote on the NBBO because directed market makers would be able to easily jump ahead of established, displayed interest by a penny. Even if BATS’s assertion about the proposal’s potential to stimulate its market makers to quote at the NBBO has any veracity, this stimulation is artificially subsidized by the ability of MMPIOs to enable market makers to internalize with select customers through the appearance of an “exchange” process.

2. In a February 24, 2011 letter responding to comments on a similar but now withdrawn proposal, BATS notes that internalization occurs today in the options market in two ways: via facilitation by a member and pursuant to directed order programs geared toward market makers. BATS notes that, with respect to facilitation, it has a one-second exposure requirement like every other exchange. The BATS proposal, however, would not have exposure requirements comparable to those in place for directed order programs on other exchanges.

BATS fails to mention that, with respect to directed order programs on other exchanges, orders are *exposed* thereby allowing more than the directed order recipient an opportunity at trading with the exposed order. This is the equivalent of the one-second exposure requirement. The BATS program, on the other hand, involves absolutely no exposure of orders and no ability

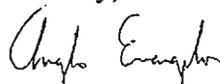
to know if non-displayed interest exists. It is designed solely to let its market makers internalize order flow from pre-selected participants. Among other things, BATS should amend its proposal to require a MMPIO and its related NBBO quote to be resident on the BATS system for at least one-second before a directed order can trade against it (although that still is not the equivalent of actual one-second exposure). Allowing BATS market makers to internalize without any exposure while precluding every other market participant from doing the same is inconsistent with Section 6(b) of the Act in that it would permit unfair discrimination between customers, brokers, and dealers. More fundamentally, we question how the BATS proposal is consistent with the SEC's prior treatment of what constitutes an "exchange" under the Act. The SEC has appropriately insisted that an exchange provide order exposure and interaction on the exchange. The BATS proposal deviates from these concepts dramatically.

3. We believe the proposal conflicts with Rule 602 of Regulation NMS (the "Quote Rule"). The Quote Rule, among other things, requires responsible brokers and dealers to be firm for their quotes. As a result, when CBOE adopted our aforementioned rules for a Penny Price Improvement Program, an explicit requirement of our program was that the non-displayed penny interest of a CBOE market maker be firm for all interest received by CBOE.¹ By contrast, BATS's proposal would only require the MMPIO to be firm for pre-selected directed order participants (as opposed to all incoming interest received by BATS). This seems inconsistent with the requirements of Rule 602, the Commission's discussion of the Quote Rule in the CBOE Penny Price Improvement Program approval order, and past precedent on the particular subject matter.

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Consistent with the comments provided above, CBOE respectfully requests that the Commission initiate proceedings to disapprove the BATS proposal. BATS has not sufficiently justified some of the very controversial aspects of the filing and it is our belief that those features are inconsistent with the Act and inconsistent with requirements imposed on other options exchanges. If you have any questions regarding this letter, please contact Joanne Moffic-Silver, General Counsel, at 312-786-7462 or me at 312-786-7464.

Sincerely,


Angelo Evangelou

cc: Robert Cook, SEC, Division of Trading and Markets
James Brigagliano, SEC, Division of Trading and Markets
Heather Seidel, SEC, Division of Trading and Markets

¹ See Securities Exchange Act Release No. 57716 (April 25, 2008), 73 FR 24329, 24330 (May 2, 2008)(SR-CBOE-2007-29).