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December 28, 2010

Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

Re: File No. SR-BATS-2010-034

Dear Ms. Norris:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to comment on the above referenced proposal ("Proposal") of BATS Exchange, Inc. ("BATS").[1] BATS proposes, among other things, to establish a program whereby market makers can execute against orders directed to them without first exposing the orders to other market participants. We believe that the Proposal does not provide for adequate exposure of directed orders and inappropriately fosters internalization in the options market. Therefore, we believe that the Commission should initiate proceedings to disapprove the filing.

Specifically, BATS proposes to implement an order type called a "Market Maker Price Improving Order." This would be an order from a BATS options market maker to buy or sell an option that has a displayed price and size, along with a non-displayed price at which the market maker is willing to trade with a Directed Order from another market participant that the market maker has pre-selected. The non-displayed price is only executable against a marketable Directed Order if the displayed price is at the national best bid (for a Directed Order to sell) or national best offer (for a Directed Order to buy). Significantly, there is no exposure of a Directed Order. The only opportunity for other market participants to execute against a marketable Directed Order before it is matched against the non-displayed price of a Market Maker Price Improving Order is if they have pre-existing non-displayed orders on the BATS order book at prices equal to or better than the non-displayed price of the Market Maker Price Improving order.

- **There is no realistic ability of other market participants to compete for directed order flow with pre-existing non-displayed prices.**

Under the Proposal, BATS market makers will be able to internalize Directed Orders without giving other market participants a meaningful opportunity to participate in

[1] Exchange Act Release No. 63403 (December 1, 2010), 75 F.R. 76059 (December 7, 2010) (SR-BATS-2010-034).

the execution of the orders. By definition, the non-displayed prices of other Market Maker Price Improving Orders are not available for execution against orders directed to a particular BATS market maker. Thus, only pre-existing non-displayed interest from non-market makers will potentially interrupt the internalization of Directed Orders. Additionally, since there is no exposure of the order before it is matched against a Market Maker Price Improving Order, there is no opportunity for other market participants to effectively compete for the orders at the same or better prices than the market maker to whom the order was directed. This is of particular importance for retail investors, whose orders are most likely to be "directed" under the Proposal.

Several aspects of the Proposal increase the opportunity for BATS market makers to internalize orders directed to them by limiting the ability for other market participants to compete effectively. First, BATS options market makers are only at risk at the non-displayed prices of a Market Maker Price Improving Order for orders that are entered by BATS members with whom the market maker has a relationship. These relationships will pre-define what types of orders are directed to the market maker, giving the market makers an inherent advantage over all other market participants whose non-displayed interest is at risk to all marketable orders entering the BATS market. Because market makers will not be at risk of being executed by non-profitable order flow or by other market professionals like all other BATS participants, the market makers will be able to enter better non-displayed prices.

Moreover, the market makers' pricing advantage is enhanced because Price Improving Orders, which theoretically might provide non-displayed interest that interacts with incoming marketable Directed Orders, are limited to prices that are smaller than the minimum price variation in the security. In contrast, Market Maker Price Improving Orders can be entered in penny increments regardless of the minimum trading increment for the option. Therefore, in those options with penny trading increments, market makers will be able to internalize orders directed to them at prices that improve upon the best bid or offer by only a penny, with the only potential "competition" coming from pre-existing non-displayed orders at the midpoint of the NBBO.[2]

For example, if the NBBO is 10 cents wide, that means there would have to be pre-existing non-displayed interest that improved upon the NBBO by five cents. Thus, there is no opportunity for competition at a price that improves upon the NBBO by one, two, three or four cents, which equates to a 100 percent execution guarantee at those prices. Moreover, and as noted above, the pre-existing non-displayed interest improving the NBBO for five cents would need to be from non-market-makers, further ensuring that that would be no real interference in internalizing the order.

This form of internalization goes well beyond anything the Commission previously has approved in the options markets. While some equity markets permit

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[2] The ISE notes that the Commission has not previously allowed options exchanges to offer mid-point pricing in options trading in penny increments. In fact, as part of its penny pilot filings, the Commission required the ISE to exclude mid-point pricing under Rule 716 for options trading in penny increments as a condition to approving those filings. See Exchange Act Release No. 54603 (October 17, 2006), 71 F.R. 62024 (October 20, 2006) (SR-ISE-2000-62).

mid-point, sub-penny matches,[3] the equity and options market structures remain significantly different. In the equity markets, internalization is the norm through, among other methods, trade reporting facilities.[4] In the options markets, the Commission has permitted trading vehicles with "hidden prices" only if there is some display of the added size of the order and the hidden portion of the order is executable against any incoming order.[5] In the BATS proposal, only a small subset of orders are eligible to be executable against the BATS Market Making Price Improving Orders.

Overall, the Proposal places extreme and unreasonable burdens on the very limited potential opportunity for other BATS participants to interact with directed order flow. As a result, the Proposal is designed not to foster competition, but to assure BATS market makers will be able to internalize orders directed to them.

- **The Proposal lacks any of the safeguards the Commission has required of other options exchanges.**

Market participants are willing to offer better prices and larger sizes if they are given the opportunity to respond to a specific order. This is why the other options exchanges offer various forms of auctions to provide opportunities for other market participants to compete for orders before they are allowed to be internalized by a directed market maker.[6] In this respect, the Commission has scrutinized in great detail the level of competition occurring within the one-second auctions offered by the ISE and other exchanges to assure that the exposure of orders is actually providing a meaningful opportunity for other market participants to interact with orders being internalized.[7] It would be inconsistent for the Commission to approve the BATS Proposal that lacks any exposure period whatsoever when it has required such a detailed analysis of whether our exposure period is effective in fostering competition for orders directed to market makers.

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[3] *See, e.g.*, EDGEX Exchange, Inc. Rule 11.5(c)(7).
[4] *See* http://www.nyse.com/pdfs/5023_TRF_OneSheet.pdf.
[5] See Exchange Act Release No. 58486 (September 8, 2008), 73 F.R. 53298 (December 15, 2004) (SR-ISE-2010-034), regarding the ISE's non-displayed penny quotes, for a discussion of the types of non-displayed orders the Commission has permitted in the options market.
[6] Under the ISE rules, when an order is directed to a market maker, the market maker must either enter the order into the Price Improvement Mechanism or release the order to execute against the ISE book. The Price Improvement Mechanism exposes the order for one second to all other ISE market participants and the directed market maker is only guaranteed 40 percent of the order at its price.
[7] Indeed the Commission requires the exchanges to provide numerous detailed monthly statistics regarding the amount of price improvement at various levels and by how many different market participants. See Exchange Act Release No. 50819 (December 8, 2004), 69 F.R. 75093 (December 15, 2004) (SR-ISE-2010-034). The Commission subsequently required that ISE submit additional monthly statistics regarding executions for under and over 50 contracts executed in the Price Improvement Mechanism. See Exchange Act Release No. 58197 (July 18, 2008), 73 F.R. 43810 (July 28, 2008) (SR-ISE-2008-60). And most recently the Commission required that ISE provide monthly statistics as a condition to adopt an auto-match feature to the Price Improvement Mechanism and Facilitation Mechanism. See Exchange Act Release No. 62644 (August 4, 2010), 75 F.R. 48395 (August 10, 2010) (SR-ISE-2010-61).

The Commission has also required that market makers cede priority at the NBBO when they determine not to provide price improvement to orders directed to them.[8] As a result, there is a "cost" to the market makers in exchange for receiving the opportunity to trade with directed order flow. This cost has been eliminated in the BATS Proposal, as there is no consequence when an order is directed to a market maker that has not entered a Market Maker Price Improving Order. As a result, a market maker on BATS can determine, on a quote-by-quote basis, whether it is necessary for it to offer price improvement to interact with orders directed to it. There will be no need for a market maker to enter a Market Maker Price Improving Order when the market maker has priority on the BOX book.

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For the reasons discussed above, we request that the Commission initiate proceedings to disapprove the BATS Proposal to allow orders to be directed to BATS market makers without a meaningful opportunity for other BATS participants to participate in the execution of the orders and without the safeguards the Commission has required of other options exchanges. The Commission should require BATS to conform with SEC precedent and expose orders for at least one second and implement a 40 percent limit on execution guarantees for directed market makers as it has required of other options exchanges that allow orders to be directed to market makers.

Sincerely,

Michael J. Simon
Secretary

cc: Robert Cook, Director, Division of Trading and Markets
James Brigagliano, Deputy Director, Division of Trading and Markets
Heather Seidel, Associate Director, Division of Trading and Markets

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[8] On the ISE, if a directed order is released by the directed market maker, the directed market maker loses its priority on the ISE book. In fact, all other trading interest is executed first and then the order is exposed for one second before the directed market maker is permitted to execute against the order at its publicly available price.