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<u>**VIA E-MAIL AND FEDERAL EXPRESS**</u>

RECEIVED
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OFFICE OF THE SECRETARY

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

Re: <u>**Release No. 34-64132 – File No. SR-BATS-2011-009**</u>

Dear Ms. Murphy:

NYSE Euronext, on behalf of its subsidiary options exchanges, NYSE Arca Inc. ("NYSE Arca") and NYSE Amex LLC ("NYSE Amex"), appreciates the opportunity to comment further on the BATS Exchange, Inc. ("BATS") proposal ("Proposal") with the Securities and Exchange Commission (the "Commission") to establish a Directed Order Program on the BATS Exchange Options Market.[1] Specifically, we are seeking to correct the inaccurate statements made in the BATS letter (the "BATS Letter"), dated June 2, 2011, responding to comments that we and other market participants had submitted on the Proposal.[2]

In particular, NYSE Euronext finds the BATS Letter to contain multiple inaccuracies regarding the functionality offered through existing preferencing and directed order mechanisms. As set forth below, we highlight several of BATS' misstatements, clarify the way these mechanisms actually work in today's marketplace, and point out that the BATS Letter fails to address our previously-stated concerns about inferior customer executions in any way.

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1 *See* Securities Exchange Act Release No. 64132 (March 28, 2011), 76 FR 18280 (April 1, 2011) (SR-BATS-2011-009). Capitalized terms not defined herein shall have the meaning in the Proposal.

2 *See*, *e.g.*, Letter re: <u>Release No. 34-64132 – File No. SR-BATS-2011-009</u>, from Janet L. McGinness, Senior Vice President and Legal & Corporate Secretary, NYSE Euronext, to Elizabeth M. Murphy, Secretary, Commission, dated April 21, 2011.

BATS' Description of Existing Directed Order Programs is Inaccurate

Presently, NYSE Amex, CBOE, ISE and Nasdaq OMX PHLX offer order flow providers ("OFPs") the ability to identify a particular market maker as the preferred liquidity provider for their order flow.[3] In describing these programs, the BATS Letter states that "in other, existing directed order programs, while avoiding the risk of trading against all incoming orders, directed order receiving firms are guaranteed an allocation of the orders directed to them as long as they are willing to only match competitive prices," and that "[i]n these directed order programs, firms can react *a posteriori*, with a full set of information on the orders and their parameters."[4]

This is incorrect. On NYSE Amex, for example, an order directed to a preferred liquidity provider is sent using a Directed Order.[5] When this occurs, if the preferred liquidity provider is quoting at the NBBO (*i.e.*, at the National Best Bid for sell orders or on the National Best Offer for buy orders), the order will instantly execute and the preferred liquidity provider will receive an enhanced allocation equal to the greater of their pro-rata share or 40% of the contracts to be allocated after all Customer trading interest at that price has been filled. Since the preferred liquidity provider must be quoting at the execution price *before* the order arrives, there is no execution guarantee. Nor is there any opportunity for the preferred market maker to match competitive prices in order to receive any part of the order once the order has been received by the Exchange. Indeed, if the preferred liquidity provider is not at the NBBO when the order arrives, they have no opportunity whatsoever to participate in the trade "*a posteriori*," in direct contrast to the claim made in the BATS rebuttal letter. Further, it is our understanding that there is *no* instance when a market maker is able to react "*a posteriori*, with a full set of information on the orders and their parameters" under any of the preferencing programs that exist currently.

Existing Directed Order Programs Require Quotes At Risk To All Participants

BATS further states that "[t]he requirement for market makers to be on the NBBO and *at risk of trading against all incoming orders* is a competitive burden that is placed on market makers in the BATS directed order program," and that "[t]his competitive burden is *not* present in other, comparable programs."[6]

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3 *See* NYSE Amex Rule 964.1NY Directed Orders; CBOE Rule 8.13 Preferred Market Maker Program; Supplementary Material .03 to ISE Rule 713, Preferenced Orders; and Nasdaq Phlx Rule 1080 (l)(i)(A) Directed Orders.

4 *See* BATS Letter at 3.

5 The term "Directed Order" has an entirely different meaning in the NYSE Amex rules *vis-à-vis* the BATS proposal.

6 *See* BATS Letter at 3.

This is simply untrue. Per NYSE Amex rules, market makers *must be quoting at the NBBO* in order to receive a preferential allocation from Directed Orders. Just as important is the fact that under our Directed Order program, the preferred liquidity provider quoting at the NBBO must do so transparently and in a non-discriminatory manner, with an ordinary, displayed quote that is accessible instantaneously by *all* market participants, and not through a special order type such as BATS' proposed MMPIO that is available only to pre-selected counterparties. Furthermore, in order to receive directed orders, NYSE Amex market makers must accept a heightened quoting obligation requiring them to disseminate a legal-width quote in options series within their allocation 90% of the time; no comparable requirement exists on BATS.

To our knowledge, the preferencing programs in place at other exchanges work in a similar fashion to the program on NYSE Amex. In stark contrast to these programs is the BATS Proposal, which would allow liquidity providers to offer their best price only to pre-selected OFPs. We believe that if the BATS Proposal were to be approved, liquidity providers operating through BATS will have the ability to discriminate on whatever basis they deem appropriate, to the ultimate detriment of the market. Accordingly, we believe that BATS has absolutely no basis to argue that their proposal somehow imposes an added or novel "competitive burden" on market makers in exchange for allowing them an unprecedented opportunity for 100% internalization.

<u>Existing Price Improvement Mechanisms Provide No Internalization Guarantees</u>

Neither of NYSE Euronext's options markets presently offers functionality that provides for potential price improvement via electronic auction. BOX, CBOE, ISE and Nasdaq OMX PHLX, however, all offer functionality that, while differing somewhat from exchange to exchange, share a transparent, competitive auction mechanism wherein multiple participants compete to trade against orders submitted for price improvement.[7] In all of these programs, the entity that submits the order into the price improvement mechanism ("Initiator") must typically guarantee the entire order a fill at a price equal to or better than the NBBO. Upon submission into the auction, participants are given one second to respond to the auction notice with the price(s) and size(s) at which they would be willing to trade with the order. At the conclusion of the auction, the order submitted for price improvement receives fills at the best price(s) received. While it is true that the Initiator is generally entitled receive 40% of the trade if it executes at their response price, if there is better priced interest for sufficient size, it is possible that the Initiator receives nothing. In other words, the Initiator, guaranteeing the full size of the order at a price equal to or better than the NBBO, receives no execution in

[7] *See* BOX Rules Chapter V, Section 18 The Price Improvement Period; CBOE Rule 6.74A Automated Price Improvement Mechanism; ISE Rule 723 Price Improvement Mechanism For Crossing Transactions; and Nasdaq Phlx Rule 1080(n) Price Improvement XL.

return unless other auction respondents fail to collectively provide price improvement or sufficient size.

Both BOX and ISE allow market makers to receive directed orders in conjunction with their price improvement functionality. However, both of these exchanges' rules clearly state that the directed market maker must choose to either (1) guarantee the full size of the order at a price equal to the NBBO through submission into the relevant price improvement program, or (2) release the order to be handled in accordance with the rules for order processing on the exchange. Notably, neither program affords the opportunity for the directed market maker to trade with 100% of the order's size outright, since an open auction allowing market participants to compete for the order is required before the directed order market maker is allowed to trade with the order. This represents a huge distinction from the BATS Proposal, which would allow BATS market makers to selectively provide as little as $0.01 of price improvement over the NBBO in exchange for instantaneously trading with 100% of any directed order, removing the ability for other market participants to participate in the trade.

Indeed, the only way a directed market maker on BATS would *not* trade with 100% of the directed order would be if there was other non-displayed trading interest at that price or better prices, which is unlikely for several reasons. First, despite the existence of better-priced MMPIO's, if the inbound order is only directed to a single market maker, other market makers cannot participate. Second, while non-market makers can submit Price Improving Orders in non-penny names, they will be unlikely to do so because, unlike MMPIO's, these orders are accessible to all market participants, and are hence subject to substantially greater negative selection.

The BATS Proposal Will Inhibit the Level of Price Improvement

In our prior letter, we pointed out that the BATS proposal will limit the amount of price improvement available to customers. The BATS rebuttal attempts to dismiss this criticism by stating that "there is nothing in the wording of the rule ... that would cap the price improvement opportunities available."[8] While factually accurate, in making this argument BATS is ignoring the basic economic realities to which its participants will inevitably respond.

The BATS proposal would create an environment in which an integrated firm wishing to internalize order flow in Penny Pilot names can do so by continuously resting an MMPIO only $0.01 better than the NBBO and directing orders to itself. Since no other MMPIO's, irrespective of superior pricing, would be eligible to interact with these directed orders, there is no economic reason for that firm to ever offer more than a single penny of price improvement in any Penny Pilot issue. Consequently, no firm will do so. (In nickel and dime names, a firm could achieve the same result by submitting an MMPIO priced one full tick better than the best displayed price, since Price Improving Orders available to other market

8 *See* BATS Letter at 6.

participants may only offer less than one tick of price improvement.) While no cap on permitted price improvement is explicitly written into BATS' proposed rule, as we and several other commenters have pointed out, a *de facto* cap will nonetheless exist, to the severe detriment of customers who today have the opportunity to receive superior price improvement through various transparent auction mechanisms.

Significant Concerns about Inferior Customer Fills Remain

In its letter, BATS states that the Proposal "reinforces the primacy of best price, and does not diminish or alter it in any way."[9] This is a remarkable statement given their description of how the Proposal actually works. An example from our prior letter describes multiple market makers who have each submitted MMPIO's available to the same OFP: for instance, one market maker is willing to pay $1.00 for a given option, a second is willing to pay $1.01, and a third is willing to pay $1.03. We expressed concern that if the OFP directs a customer sell order only to the first market maker, the customer would sell the option at $1.00 despite the presence of other market makers who have explicitly indicated a desire to pay $1.01 and $1.03 to the same customer for the same option. In response, BATS explains:

> "If a firm enters an order and trades with [a market maker] at $1.00, in price-time priority, they have not traded through $1.01 and $1.03 prices. Rather, there are no $1.01 nor $1.03 prices available. Those prices exist on the BATS Options book only when the various market makers receive Directed Orders from their approved participants."[10]

It is clear from this quote that BATS is attempting to obfuscate the issue by arguing about when a price is "available"; in point of fact, it is clear that $1.03 is the best price in the above example and allowing the order to fill at $1.00 does nothing to "reinforce the primacy of best price." It is further remarkable that BATS describes this scenario as "price-time priority" when clearly the best price, $1.03, is not being given priority at all but is rather being intentionally held off the book, and discarded by BATS as somehow not "available," despite the fact that *the market maker who submitted the $1.03 bid using an MMPIO has indicated an explicit willingness to trade at that price with the OFP in question.*

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The BATS Proposal will enable unprecedented opportunities for 100% internalization, entirely at odds with the Commission's thoughtful and long-held view that internalization rates should generally be limited to 40% with few exceptions. Consequently, it is our view that if the Proposal passes it will have a significant and damaging impact on the options industry as a whole, and create a less competitive atmosphere for the investing public.

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9 *Id.*

10 *See* BATS Letter at 5.

NYSE Euronext appreciates the opportunity to correct the inaccuracies in the BATS Letter. Please do not hesitate to contact us if we can provide any further clarification.

Very truly yours,

Janet McGinness