NASDAQ OMX | PHLX

June 24, 2011

Elizabeth M. Murphy
Secretary
United States Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: File No. SR-BATS-2011-009 (the "BATS proposal")

Dear Ms. Murphy:

NASDAQ OMX PHLX LLC ("PHLX") and The NASDAQ Options Market (taken together, "NASDAQ") appreciates the opportunity to comment on the BATS Proposal that NASDAQ believes will make trading standardized options incrementally darker and less transparent by enabling market makers to trade exclusively against orders directed to them without exposing the orders to other market participants. NASDAQ previously submitted a comment letter on the BATS Proposal (the "NASDAQ comment letter").[1] BATS responded to the NASDAQ comment letter and comment letters submitted by other U.S. options exchanges (the "BATS Rebuttal").[2] BATS still has not addressed the discriminatory aspects of the BATS Proposal, and has not described how customers can obtain executions at the best price for their orders given the lack of price competition for orders that are directed to market makers.

NASDAQ believes that any proposal to make the market darker and less transparent should rest on accurate facts. The BATS rebuttal contains factual inaccuracies that should be resolved before the Commission considers them. For example, the BATS Rebuttal asserts that under various directed order programs, "a firm can react to a directed order without the risk of trading against all incoming orders, without the obligation to provide price improvement, and with the guarantee of order allocation." The BATS Rebuttal goes on to state, "[M]ore than 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. In these directed order programs, firms can react a posteriori, with a full set of information on the orders and their parameters."

In reality, under the PHLX directed order program, a market maker or specialist that receives a directed order may only participate in that order and receive a concomitant allocation guarantee if they are quoting at the NBBO *at the time of receipt* of the directed order.[3] A firm therefore does not, and cannot, "react *a posteriori*" to the directed order, and is indeed at risk of

[1] Letter from Tom Wittman, President, PHLX, dated April 21, 2011.

[2] Letter from Jeromee Johnson, Vice President, BATS Exchange, Inc., dated June 2, 2011.

[3] *See* PHLX Rules 1014(g)(viii) and 1080(l)(ii).

trading against all incoming orders.[4] The BATS Rebuttal incorrectly concludes that "[T]his competitive burden is *not* present in other, comparable programs." Such competitive burden is, in fact, present on the PHLX.

Additionally, NASDAQ believes BATS inaccurately describes the competitive fairness of its proposal. Specifically, BATS asserts that:

> ... firms wishing to receive directed orders have no guarantees of any order allocation. Rather than creating an environment that would foster internalization ... or ... encourage internalization without transparency, the [BATS] Proposal would foster efficient competition by placing all firms on a more level playing field and incenting effective competition through price.

On the contrary, only a BATS market maker receiving directed orders from a specified order flow provider (a "directed BATS market maker") can enter a dark bid or offer at the improved price. The only "competition" at that price level would be a non-directed market maker or other non-directed market participant who just happens to place displayed limit order on the BATS book at the dark improved price. Other market participants would be unaware that they are "competing" with the dark price. The BATS Proposal, while not explicitly guaranteeing a trade allocation by rule, effectively accomplishes a guarantee by allowing only directed BATS market makers to enter improved, dark prices. Given the small number of BATS market makers, much less directed BATS market makers, this effectively guarantees a 100% trade allocation. This is not a more level playing field.

The next inaccuracy in the BATS Rebuttal is found in the explanation of the BATS priority rules concerning Market Maker Price Improving Orders ("MMPIOs"). Specifically, "[I]n all cases the (BATS) Proposal would require (MMPIOs) to cede priority to any other interest on the BATS Options Book, displayed or non-displayed, at the same or better price as the non-displayed price of the (MMPIO), regardless of time priority."

This explanation does not capture the acute competitive disadvantage that the BATS Proposal creates for non-directed interest on the BATS Options Book vis-à-vis the dark price submitted by the directed BATS market maker. The dark MMPIO is not displayed whereas non-directed participant interest must be displayed. The dark MMPIO is at a distinct advantage here because the directed BATS market maker has actual knowledge of both its own non-displayed price and the non-directed participant's price, whereas the non-directed participant has no actual knowledge of the BATS market maker's dark price. Because of this intentional lack of transparency, a non-directed participant cannot compete effectively with the dark market proposed by BATS.

The BATS Rebuttal indicates that BATS has determined to amend the BATS Proposal to make clear that an order flow provider can elect to direct an order to multiple market makers,

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[4] If the directed specialist or market maker is quoting at the NBBO and a non-directed order is executed before a directed order is received, the directed specialist or market maker would participate in the execution as a regular participant, with no guarantee of order allocation as a directed participant. *See* PHLX Rule 1014(g)(vii).

such that it will execute against the market maker with the best conditional price. While attempting to explain the possibility of inferior executions in the handling of multiple MMPIOs, BATS acknowledges that although market makers may be willing to pay an improved price for an option, those improved prices are "by their very nature, conditional." This proposed amendment actually exacerbates the discriminatory nature of the original BATS Proposal. The Original BATS Proposal permits an order flow provider to direct orders to a single market maker who can avoid other order flow providers who are not on their selected list of directed order flow providers, and the single directed BATS market maker will not execute any other order flow provider's order at the dark improved price. This is akin to quoting a price, and being firm for certain contra parties while simultaneously non-firm for other contra parties. The proposed amendment multiplies the effect of this discriminatory practice by enabling multiple market makers to avoid certain order flow providers by making their improved prices hidden and discriminatory. This is a significant impediment to transparency and fair competition in the options industry.

NASDAQ appreciates the opportunity to highlight inaccuracies in the BATS rebuttal, its conditional, selective price improvement program which will disenfranchise customers whose interest is not represented by a specified order flow provider, and about the BATS Proposal's negative impact on competition, transparency, and the options markets as a whole. Accordingly, NASDAQ respectfully requests that the Commission institute proceedings to disapprove the BATS Proposal.

Respectfully submitted,

Thomas A Witt

Tom Wittman

cc: The Hon. Mary L. Schapiro, Chairman
The Hon. Kathleen L. Casey, Commissioner
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
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