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Via Electronic Mail

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.W.
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 submitting this supplemental comment letter in response to the June 2, 2011 letter submitted by the BATS Exchange, Inc. (“BATS”) regarding the above-referenced proposed rule change.¹ Through the proposed rule change, BATS is seeking to establish a directed order program. Under the program: Only a “directed market maker” would be permitted to enter a “directed market-maker price improving order,” which would contain both a displayed price and a non-displayed price. While the displayed price would be accessible to all market participants, the non-displayed price would only be accessible to order entry firms that send “directed orders” that designate the particular directed market maker. To qualify, the directed market maker would also have to indicate that it will accept directed orders from the particular order entry firm. No other market participants would have any access the directed market maker’s non-displayed order (regardless of the option series trading increment) and no other market participants would have the same ability as a directed market maker to enter non-displayed orders (in options series trading in \$0.01 increments).² Thus, access to participate in this directed order program and trade at the

¹ See letter from Jerome Johnson, BATS, to Elizabeth M. Murphy, Secretary, SEC dated June 2, 2011.

² In option series trading in \$0.05 and \$0.10 increments, it is our understanding that other market participants may enter “price improving orders” or “PIOs” in penny increments. This type of penny-price-improving-orders-for-series-trading-in-non-penny-increments program is similar to programs in place at various options exchanges. PIOs differ from market maker directed orders in several respects. For example, PIOs are not available for option series trading in \$0.01 increments. (The Exchange notes that the most active classes, based on national volume, participate in the Options Penny Pilot Program.) PIO orders are entered in a non-displayed penny increment and rounded to the nearest standard increment for display purposes (by contrast, a directed market maker entering a directed order would separately specify both a non-displayed price and a displayed price). In addition, both the non-displayed and the displayed portion of a PIO are accessible by all market participants; by contrast, only the displayed portion of a directed market maker order would be accessible by all market participants; the non-displayed portion would only be accessible to a select subset of market participants. Thus, for example, under the existing rules, in a \$0.05 series, a market participant could enter a PIO to sell at \$1.23. The order is rounded and displayed at a price of \$1.25. All incoming orders, regardless of sender, are eligible to trade against the PIO at the non-displayed price of \$1.23. By

non-displayed prices would be restricted to a select subset of the BATS market. All other market participants, including retail investors, would be denied access to participate.

As described in more detail in our prior comment letters,³ we have fundamental concerns about various aspects about the proposal that BATS has failed to address. BATS has failed to address these concerns and the BATS proposal fails to satisfy the statutory requirements for rule filings under the Securities Exchange Act of 1934 (the “Act”). In particular:

1. The BATS proposal would only allow BATS directed market makers to submit non-displayed penny interest in penny classes and would provide only a select sub-set set of order entry firms with access to trade against that non-displayed interest. All other market participants would be denied access to submit non-displayed penny interest and from participating at those non-displayed prices. BATS has provided no justification for limiting access to trade to a select subset of market participants and denying access to all others. The proposal is not consistent with the requirements for a national securities exchange under Section 6(b) of the Act, including, but not limited to, the requirements that rules be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, to protect investors and the public interest, and not be designed to permit unfair discrimination.

2. The BATS 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 rules for a Penny Price Improvement Program (described in more detail below), an explicit requirement of our program was that the non-displayed penny interest of CBOE market makers be firm for all interest received by CBOE.⁴ By contrast, the BATS proposal would only require directed market maker price improving orders 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. BATS has failed to address this disparity or provide any, let alone a sufficient, justification for the distinction.

comparison, under the proposed rule change, a directed market maker would have the added, exclusive ability to enter a directed market maker price improving order. For example, a directed market maker could enter such an order with a non-displayed price of \$1.23 and a displayed price of \$1.25. The non-displayed \$1.23 would not trade against anyone except a directed order from an order entry firm from whom the directed market maker has indicated that it will accept directed orders. If we change the example to a \$0.01 series, PIOs are not available. Most market participants would not be eligible to non-displayed orders. The exception would be a directed market maker, who would be able to enter a directed market maker price improving order (*e.g.*, enter a sell order with a non-displayed price of \$1.23 and a display price of \$1.24). It is our view that BATS has not provided sufficient justification for limiting access to this order type functionality to only directed market makers, even in the context of \$0.05 and \$0.10 series. Our concerns are discussed more fully below.

³ See letters from Angelo Evangelou, Assistant General Counsel, CBOE, to Elizabeth M. Murphy, Secretary, SEC dated April 27, 2011 (in reference to SR-BATS-2011-009) and December 28, 2010 (in reference to SR-BATS-2010-034, a predecessor filing that was replaced by SR-BATS-2011-009).

⁴ See Securities Exchange Act Release No. 57716 (April 25, 2008), 73 FR 24329, 24330 (May 2, 2008)(SR-CBOE-2007-29).

3. The BATS proposal would not have any exposure requirements comparable to other directed order programs. In its response letter, BATS discusses the fact that, in order to trade against an incoming directed order, a directed market maker would be required to be quoting with a directed market maker price improving order that has a displayed price equal to the NBB or NBO and that displayed portion of the directed market maker price improving order would be available and at risk to trade with all members of the exchange. BATS then goes on to say:

Many of the commenters wish to have this NBBO requirement both ways. They point out non-MMPIO submitting firms wishing to compete for directed orders must submit orders that are at risk to all market participants and thus at a disadvantage. ... The 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. This competitive burden is *not* present in other, comparable programs. More 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 the ISE and other's 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*. BATS' Proposal turns this structure on its head. Firms must act a priori. They must enter orders *that assume the risk* of trading with all participants. They must *commit to price improvement* without knowing the details of the order. And firms wishing to receive directed orders *have no guarantees* of any order allocation. Rather than creating an environment that would 'foster[s] internalization' or 'encourage internalization without transparency,' the Proposal would foster efficient competition by placing all firms on a more level playing field and incenting effective competition through price." *(emphasis original, footnotes omitted)*

BATS appears to have either misunderstood or mischaracterized the existing exchange programs, as well as its own proposal. Just to name a few things: On all markets, orders displayed at the NBBO assume the risk of trading with all participants (BATS is not unique in this regard). It is the non-displayed component and the unique aspects of the BATS proposal compared to others that warrants further review. Moreover, on BATS, a directed market maker would have a guarantee, namely a guarantee of the exclusive participation right to trade with an incoming directed order at a non-displayed price to the exclusion of all other market participants. Before any decision is made regarding the BATS proposal, we believe it is of utmost importance that there at least be an accurate understanding of the facts about existing options market programs and the stark contrast to the BATS directed market maker proposal:

- Various options exchanges have market maker programs where a market maker that is quoting at the NBBO is afforded a participation entitlement to trade against an incoming marketable order that has "preferenced" to that market maker, subject to the market

maker satisfying certain obligations. These programs only pertain to displayed bids and offers, there is no non-displayed component. For example, CBOE's program is described in CBOE Rule 8.13, Preferred Market Maker Program. To be eligible to participate in this program, a preferred market maker will only receive a participation entitlement if the preferred market maker has an appointment in the relevant option class *and is quoting at the NBBO*. In addition, the preferred market maker may not be allocated more than the quantity the market maker is quoting, the participation entitlement rate (e.g., 40%) is based on the number of contracts remaining after all public customer orders on the book at the best price are satisfied, and the preferred market maker must comply with the quoting obligations applicable to its market maker type (e.g., MM, DPM, e-DPM) and must provide continuous electronic quotes in at least 90% of the series of the class. Under these programs, market makers do not have the ability to act a posteriori and they must enter orders *that assume the risk* of trading with all participants. Market makers wishing to receive directed orders *have no guarantees* of any order allocation. Importantly, under these programs no one is denied access or subject to unfair discrimination – all market participants are eligible to submit incoming orders and rest orders in the same fashion as the preferred market maker. Incoming orders benefit from this transparency and competition. The proposed BATS process denies customers orders of any semblance of transparency and competition.

- Various options exchanges also have penny price improvement programs that permit users to submit orders with both a displayed and non-displayed prices. These programs are limited to option series that are quoted in increments above \$0.01 (*i.e.*, \$0.05 and \$0.10 series). The BATS proposal should be similarly limited. Importantly, all market participants are eligible to enter penny price improvement orders (access is not limited to just a subset of market makers) and all incoming orders of market participants are eligible to trade against resting penny price improvement orders at the non-displayed price (access is not limited to just a select subset of order entry firms that a select market maker designates as being eligible). In addition, the orders are priced in \$0.01 but rounded to the nearest standard increment that does not violate the limit price (*e.g.*, a penny price improving order to sell priced at \$1.24 would be rounded and displayed at \$1.25). For example, CBOE's program is described in CBOE Rule 6.13B, Penny Price Improvement. Also important to note and as discussed above, as required by the SEC, the non-displayed interest of market-makers (referred to in the rules as indications of interest) are firm for all interest received by the Exchange. (In fact, all non-displayed penny price improvement interest, whether submitted by a market maker or non-market maker, is accessible to trade by all market participants, subject to price priority.) Under these programs, firms (including market makers) must act a priori. They must enter orders *that assume the risk* of trading with all participants. They must *commit to price improvement* without knowing the details of the order. And firms wishing to receive directed orders *have no guarantees* of any order allocation (for example, incoming orders that could trade against penny price improvement interest automatically execute against that interest pursuant to CBOE's normal allocation procedures). Again, importantly, under these programs no one is denied access or subject to unfair discrimination – all market participants are eligible to submit penny price improving orders and all incoming orders are to trade against them. By contrast, the BATS proposal would only require directed

market maker price improving orders to be firm for pre-selected directed order participants (as opposed to all incoming interest received by BATS). BATS contention that its directed market maker price improving orders are at “conditional price improving prices [that] are not actually available” is not a sufficient response. As discussed above, conditioning a non-displayed quote (or indication or whatever other label is put on it) on the basis that it is only good for a select subset of market participants seems inconsistent with the requirements of the Quote Rule and the SEC’s analysis of the Quote Rule in the approval order for CBOE’s Penny Price Improvement Process.

- Finally, various options exchanges have price improvement auction programs that permit users to electronically expose agency orders for price improvement by market participants, either in a crossing or non-crossing scenario. Some of these programs include provisions that allow market makers to expose the agency order and seek a market maker participation entitlement. This type of order auction program is generally referred to as a Directed Market Maker program, *e.g.*, ISE Rules 723 and 811. BATS fails to mention that, under these programs, orders are exposed for generally at least one second thereby allowing more than the directed order recipient an opportunity at trading with the exposed order. BATS also fails to mention that, under these programs, if a market maker elects to be a directed market maker, it must meet certain quoting obligations and must accept directed orders from all market participants and cannot reject a directed order. Further, a directed market maker is only provided a participation entitlement (generally 40%) if it is quoting at the best price at the conclusion of the auction, and is also subject to certain NBBO guarantees and yielding requirements. The BATS proposed 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 directed market makers internalize order flow from pre-selected participants. Allowing BATS directed 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.

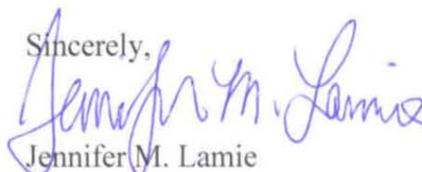
4. BATS should not be permitted to unilaterally amend its proposal without first publishing the amendments for comment. As was noted by CBOE and other commenters, the BATS proposal would allow for inferior executions, in apparent violation of firm quote and general book priority requirements that an exchange not allow an order to execute through its market. BATS acknowledged the problem (albeit for business reasons and not because of its inconsistency with rule requirements) and in its response letter proposed to unilaterally revise its proposal to allow for an incoming directed order to execute against multiple non-displayed directed market maker orders. We believe that any such revisions should come in the form of an amended filing that is published and opened for public comment. Such a change would still not remedy many of the issues raised above (*e.g.*, creation of sub-markets, lack of firm quote, etc). Moreover, this revision does not address such issues as how multiple non-displayed orders would be prioritized (*e.g.*, what happened is there are two directed market maker price improving orders

at the same non-displayed price?) and the public should have an opportunity to understand and comment before any such changes would be made to the proposal.

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For the foregoing reasons, CBOE respectfully asks that the Commission initiate proceedings to disapprove the BATS proposal. Even with its response letter, BATS has failed to sufficiently justify some of the very controversial aspects of the filing and it continues to be our belief that those features are inconsistent with the Act and the requirements imposed on other options exchanges. We are available to discuss any aspects of the proposal or our comment letters. If you have any questions, please contact Joanne Moffic-Silver, General Counsel, at 312-786-7462 or me at 312-786-7576.

Sincerely,



Jennifer M. Lamie

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