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April 21, 2011

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-2011-09

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 trade against orders directed to them without first exposing the orders to other market participants. This is the second such proposal submitted by BATS.[2] ISE submitted a comment letter with respect to the first proposal,[3] and we request that the Commission include that comment letter in the record for this filing as well. We continue to 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 Proposal.

In our first letter, we discussed in detail two troubling aspects of the Proposal to implement an order type called a "Market Maker Price Improving Order":[4]

- There is no realistic ability of other market participants to compete for directed order flow with pre-existing non-displayed prices.
- The Proposal lacks any of the safeguards the Commission has required of other options exchanges.

[1] Exchange Act Release No. 64132 (March 28, 2011), 76 F.R. 18280 (April 1, 2011) (SR-BATS-2011-09).
[2] Exchange Act Release No. 63403 (December 1, 2010), 75 F.R. 76059 (December 7, 2010) (SR-BATS-2010-34).
[3] Letter from Michael Simon, Secretary, ISE, December 28, 2010.
[4] A Market Maker Price Improving Order is 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.

These two issues remain unaddressed in the current Proposal, and we request that the Commission consider the details of our previous comments carefully along with the additional discussion we provide in this letter. In this letter we focus on the lack of a competitive price discovery process for retail customer orders.

Two-Tiered Options Markets

The Commission extended the firm quote rule to cover listed options in 2000. At that time, it recognized that the prices and sizes of the quotations that market makers were willing to provide to public customers might be better than those that they would be willing to provide to other professionals in the market.[5] Accordingly, after careful consideration of two alternative proposals, the Commission adopted a rule that allowed exchanges to establish minimum quotation sizes that could be smaller for professionals than for public customers. However, competition among the options exchanges resulted in quotations that are firm for all orders for the full size of the displayed price. Consequently, the industry developed an alternative way to provide retail customers with better prices than those reflected in the public quotation through various forms of price improvement auctions that are not publicly displayed.

Thus, the industry effectively turned this two-tiered market on its head. Instead of having the national best bid and offer ("NBBO") reflect the best prices available for retail customers with a non-public pool of liquidity available for larger-size professional orders, we now have publicly displayed bids and offers that reflect the liquidity providers' exposure to other professionals in the market, with non-public price discovery for smaller retail orders through various price improvement processes.

This two-tiered market structure can be beneficial to public customers so long as the pricing process provides the best possible price to the customer. In this respect, the current structure works well because the non-public price discovery is open to most, if not all, of an exchange's members. This broad participation in the price discovery process is an important safeguard because it assures that retail customer orders are receiving the best prices regardless of other incentives that might exist in the marketplace (*e.g.,* fees, payment for order flow ("PFOF"), or internalization). In contrast, and as discussed in detail below and in our first letter, BATS' Proposal is not designed to create competition to assure that retail customer orders are receiving the best prices within the BATS marketplace.

Lack of Price Discovery for Retail Customer Orders

BATS' stated justification for its Proposal demonstrates its fundamental flaws. BATS states:

> [In] *all* cases a Market Maker Price Improving Order must include a displayed price that is equal to the NBB or NBO for such order to be eligible to execute at its non-displayed price against a Directed Order. As such, the Proposal enhances the public price discovery

[5] Exchange Act Release No. 43591 (November 17, 2000), 65 F.R. 75439 (December 1, 2000).

> process – if the market maker is not publicly quoting at the NBB or NBO at the time the Directed Order arrives to BATS Options, the market maker will only trade with that Directed Order to the extent that any other interest on the BATS Options Book at or better than the NBB or NBO and any other interest with price/time priority over the market maker's order is first satisfied. Accordingly, in order to enjoy the benefits of trading against Directed Orders, a market maker is required to publicly display a competitively priced order which is available, and hence at risk to all members.

There are three problems with this attempted justification: (1) it does not address the real issue, which is whether there will be competition at non-displayed prices to assure that the directed order is executed at the best price; (2) requiring a directed market maker to publicly display a competitive price at the NBBO is meaningless as to whether the directed retail customer order is getting the best price; and (3) requiring directed market makers to quote at the NBBO will not enhance the public price discovery process.

The fact that only the directed market maker has the ability to enter price improving orders with limited risk will make it impossible for other market participants to compete for directed orders. All other market participants, whether through publicly-displayed prices or non-displayed prices, will be at risk of trading against all incoming orders. As discussed above, the prices at which options market participants are willing to trade with professional market participants must take into consideration the additional risk involved. Market participants will provide better prices when they know the order for which it is bidding or offering is a small retail customer order. Under the BATS proposal, only the directed market maker is able to enter prices with the knowledge that they will only be executed against "safe" order flow.[6] Accordingly, BATS' claim that "all market participants can effectively compete against nondisplayed Market Maker Price Improving Orders simply by tightening the NBBO" is not true.

BATS also positions the Proposal as a better mechanism to provide price improvement because there are no execution guarantees. However, execution guarantees on the other options exchanges determine how to allocate an order among multiple participants at the best price after completing the price discovery process. In all circumstances, no participant is guaranteed anything unless it matches the best available price. Since the BATS Proposal bypasses the price discovery process altogether, the Proposal assures that retail customer orders can be executed by the

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[6] While other options exchanges' directed order programs allow market makers to specify from whom they will accept directed orders, all such programs provide an opportunity for other members to participate in an auction for the specific directed order. This allows other members to submit prices knowing the size of the order and that it is a customer order that was selected by another participant for price improvement, thereby providing a real price discovery mechanism for the order. In contrast, the BATS proposal allows directed market makers to enter prices that are only at risk to the pre-selected orders without competition from other market participants who are similarly at risk to execute against only such orders.

directed market maker with the least possible amount of price improvement over publicly displayed prices.

BATS also asserts that its proposal is better than existing price improvement programs because its directed market makers are required to be at risk at the NBBO, whereas participants on other exchanges can provide price improvement to customer orders even when they are quoting away from the NBBO. This again confuses the issue. The question is whether an exchange has a process designed to give the directed customer order the best price, not whether the member providing price improvement is at risk to the market at the NBBO. In this respect, requiring directed market markers to quote at the NBBO and yield priority to other orders at the directed market maker's hidden price should not be viewed as justification for giving directed market makers a pricing advantage over other market participants on the exchange. While the options exchanges have implemented various programs that give market makers greater allocations based on undertaking additional quoting obligations, all such programs pre-suppose that there is a legitimate price discovery process and that such enhanced allocations are only provided at the best price resulting from that price discovery process.

Finally, we note that it is questionable whether requiring directed market makers in a price-time priority system to quote at the NBBO would actually improve the quality of competition at the NBBO. We do not believe any additional liquidity would be added to the NBBO as a result of this requirement, as liquidity providers use pricing models to determine at what prices and for what sizes they are willing to quote when they are at risk to the entire market. This calculation is unlikely to change because the BATS Proposal requires directed market makers to be quoting on the NBBO. As discussed in our first letter, it will be relatively easy for market makers to avoid trading at prices that match the NBBO unless they actually want to trade at those prices. This is particularly true in a price-time priority environment such as BATS where they can simply match the NBBO for the relatively small size of the retail customer orders they are seeking to internalize, and be last in priority at the displayed price.

<u>Payment for Order Flow</u>

BATS appears to equate the price improvement provided by a directed market maker with the PFOF paid by some market makers outside of the exchange market. BATS states:

> [B]y requiring a commitment of material price improvement at the time of the market makers order entry, BATS believes the economics of the payment relationships that exist under current directed order programs will shift – away from a pure payment relationship between brokers off the exchange, to payment via price improvement on the exchange, which inures directly to the benefit of the customer orders. BATS believes that this result reflects a healthy and competitive development that will enable market

> participant[s] not part of those relationships today to better compete – on price – for valuable order flow.[7]

This conclusion is false. On all other options exchanges the customer order is priced through competition on the exchange independent from any PFOF arrangement that might exist between market makers and the brokers entering the orders. This price discovery not only provides better prices directly to the customer, but it also assures that the customer order is getting the best price available through competition.

If offering price improvement is really a substitute for PFOF, then this Proposal allows directed market makers to pay only for specific retail customer order flow, while requiring all other market participants to pay for all retail customer order flow. Essentially, all other market participants pay not only a higher tax to compete for the retail customer orders directed to a market maker, they also bear the greater cost of being at risk to the entire market.

<u>Statutory Basis for the Proposal</u>

The bases on which BATS justifies its Proposal are unfounded. In its filing with the Commission, BATS asserts that the Proposal meets the requirements of Section (b) of the Securities Exchange Act of 1934 (the "Act") for the following reasons:

> *"[I]t promotes competition for customer orders and furthers the public price discovery process by both incentivizing BATS Options Market Makers to publicly display aggressive quotes at the NBBO, as well as incentivizing BATS Options Market Makers and all other BATS Options Members to post non-displayed prices better than the NBBO."*

However, as discussed above, the public price discovery process is not benefited by the Proposal. At best it is completely unaffected by a meaningless quotation requirement intended to justify giving pricing advantage to a selected market participant. Moreover, the Proposal places insurmountable disincentives to all market participants, other than the directed market maker, from posting non-displayed prices better than the NBBO.

> *"BATS notes that the Commission has previously found consistent with the Act non-displayed order types designed to provide price improvement at prices smaller than the minimum price variation in listed options."*

There are two different variations on what the Commission has permitted: (1) price improvement auctions at prices smaller than the minimum price variation that are open to all of the exchange's members; and (2) non-displayed orders in smaller than the

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[7] BATS Letter at page 6. *See also* BATS Letter at page 4 stating: "In this regard, BATS notes market makers already retain the discretion to pay certain firms non-transparent [PFOF] amounts. The Proposal similarly retains that existing discretion for market makers, but provides a mechanism for such payments, or at least a portion of such payments, to be provided in a transparent fashion to the Directed Order in the form of price improvement over the NBBO."

minimum price variation. In the latter case, all such orders are at risk to being executed by all incoming orders from all market participants. The BATS proposal does not fall into either category because it restricts the exposure of the non-displayed order to selected order flow without an auction that allows other market participants an opportunity to compete on equal terms. The proposal is the equivalent of allowing a price improvement auction where only the directed market maker can participate in the auction, which obviously is not an auction at all.

> *"Moreover, the Commission has previously approved rules that provide specialist or market maker guarantees up to a certain percentage so long as the specialist or market maker is quoting at the NBBO and such guarantees do not rise to a level that could have a material adverse impact on quote competition with a particular exchange."*

As discussed above, such guarantees are applied after the price discovery process when there are multiple parties at the best price, whereas the BATS proposal bypasses the price discovery process altogether. Moreover, the Commission has drawn a bright line limit on the level of such participation at 40 percent of the order to assure that such guarantees do not remove the incentive for other market participants to compete. The BATS proposal would be a significant departure from this Commission policy, as it does not provide for a competitive environment, resulting in a 100 percent execution guarantee for directed market makers.

> *"While BATS' directed order program requires BATS Options Market Makers to be quoting at the NBB or NBO to be eligible to trade with an incoming Directed Order directed to it, in contrast to prior rules approved by the Commission, BATS' proposed directed order program provides no participation guarantees that could negatively impact quote competition."*

This is the same as the previous point. Instead of providing for a limit of 40 percent on a guarantee, the BATS proposal creates a different mechanism for achieving a 100 percent guarantee at the best price – the elimination of competition at the non-displayed price so that there will not be any other participants at the same price.

> *"By not providing such guarantees, BATS's [sic] proposed directed order program provides incentives to BATS Options Market Makers as well as all other BATS Options Members to aggressively quote, both at the NBBO and at non-displayed prices better than the NBBO."*

Saying the same thing three times does not make it true – there is no incentive for any participant to post non-displayed prices that are at risk to the entire market in an attempt to compete with directed market makers who have the advantage of knowing that their non-displayed prices are limited to "safe" retail customer order flow. On every options exchange, quoting at the NBBO is the minimum requirement for a market maker to trade. BATS has twisted this into the statement that if the directed market maker quotes at the NBBO they are "publicly displaying aggressive quotes."

"In addition, the Commission has previously approved rules that permit a specialist or market maker to determine the firms from which it will accept directed or preferenced orders."

This is true only in the context of entering orders into a price improvement mechanism that gives other market participants an opportunity to compete for the specific order on equal terms.

"The Commission has explicitly approved a process similar to that proposed by BATS in the equity markets in which only those members who have been permissioned by a market maker are eligible to submit directed orders to the market maker."

The options market, unlike the equities market, does not permit off-board trading. The options market requires all orders to be executed on an exchange with the underlying presumption that such exchanges provide a competitive price discovery process for retail customer orders.

"And, the Commission has implicitly approved such processes in the options markets by allowing certain price improvement auctions to exist pursuant to pilot programs, which auctions provide the ability of an options member to submit a customer order along with a contra-side principal order from the options member into a brief price improvement auction in which all members have the ability to compete for the execution. BATS' proposed rule changes are similar in nature to these price improvement auctions, except that under BATS' proposal, competition for the execution with a Directed Order occurs in the context of BATS' continuous, price/time priority auction, rather than during a separate, one-second price improvement auction."

The BATS Proposal is not "similar in nature" to a price improvement auction that gives market participants an opportunity to provide prices for a particular order knowing the size of the order and that another market participant has determined to provide it with price improvement. While there could be occasional non-displayed interest, there will be no actual competition at the non-displayed prices for the orders being directed.

"As such, concerns about customer orders potentially 'missing the market' during that exposure period are not present."

Price improving auctions provide the customer order with a guarantee of price improvement over the NBBO at the start of the auction, so there is no concern that a customer order could "miss the market." BATS is confusing the discussion of price-improvement auctions with what are known as "flash" orders. Flash orders are orders that are exposed for one second on an exchange when that exchange is not at the NBBO to give that exchange's participants an opportunity to match or better the NBBO before an order is sent to another exchange. Flash orders are not "stopped" or guaranteed a particular price, which is not the case with the price improvement auctions to which BATS is comparing its Proposal.

"That said, however, BATS has proposed to the Commission price improvement data and other data deemed necessary to evaluate the impact of the proposal."

The price improvement data that ISE and other options exchanges provide to the Commission with respect to their price improvement auctions is not related to the potential of an order "missing the market" since that is not an issue. The data requested is focused on evaluating whether the price improvement auctions, while designed to provide competitive auctions, are actually producing competitive price discovery for the customer orders being executed. We do not believe that the BATS proposal meets the initial design threshold, and therefore should not be approved by the Commission, not even on a pilot basis.

Also, as previously mentioned, BATS' proposal differs from existing price improvement auctions due to the fact that BATS Options Market Makers would have no participation guarantees.

BATS again incorrectly focuses on participation guarantees. The structure of the Proposal assures that there will be no competition at the non-displayed prices entered by directed market makers, so there is no reason for BATS to provide for explicit participation guarantees. The reality of the proposal, however, is that it provides a 100 percent execution guarantee. This does not make the BATS Proposal better, it makes it anti-competitive and inconsistent with the Act.

The Exchange notes market makers already retain the discretion to pay certain firms non-transparent payment for order flow amounts. The proposal similarly retains that existing discretion for market makers, but provides a mechanism for such payments, or at least a portion of such payments, to be provided in a transparent fashion to the Directed Order in the form of price improvement.

There is nothing "transparent" about executing directed orders at non-displayed prices. Moreover, BATS acknowledges that its directed market makers can still pay for order flow outside of the exchange just like market makers on other exchanges that have competitive price improvement auctions. In fact, the economics are the same for the market maker that provides price improvement to a customer order regardless of the mechanism used to provide it. However, under the BATS Proposal the pricing advantage given to the directed market makers will assure that they execute against a much greater percentage of the retail customer order flow directed to them and that they will always pay the minimum price improvement over NBBO since there is no auction to maximize the price improvement the customer receives. As a result, the directed market makers on BATS would actually be able to pay the directing firms more outside the exchange.

As this discussion demonstrates, BATS has not provided any statutory basis upon which the Commission could make a determination that the Proposal is consistent with the requirements of the Act.

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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 price discovery process that assures retail customer orders receive the best price. 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