

April 21, 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, Inc. (“PHLX”) and The NASDAQ Options Market (taken together, “NASDAQ” appreciates the opportunity to comment on the above rule filing proposal submitted by the BATS Exchange, Inc. (“BATS”). The BATS proposal contains certain novel features that raise questions as to whether the novel features comply with the Securities Exchange Act of 1934, as amended (the “Exchange Act”). NASDAQ requests clarity on three issues raised in the BATS proposal so that in the event NASDAQ determines to initiate a similar program, we may do so with confidence that these issues are consistent with the Exchange Act.

Handling of Multiple Market Maker Price Improving Orders

The first issue raised involves proposed Rule 21.1(d)(13), entitled Market Maker Price Improving Orders, which are orders from a BATS Options Market Maker to buy or sell an option that have a displayed price and size and a non-displayed price at which the BATS Options Market Maker is willing to trade with a Directed Order. The non-displayed price of the Market Maker Price Improving Order would not be entered into the BATS Options Book, but would be, along with its displayed size, converted to a buy or sell order at its non-displayed price in response to a Directed Order directed to the BATS Options Market Maker.

The BATS filing is unclear regarding how multiple Market Maker Price Improving Orders are handled. Specifically, when two Market Maker Price Improving Orders that are on the National Best Bid have different non-displayed prices and a Directed Order is received that is directed to the Market Maker Price Improving Order with the inferior non-displayed price, we believe the order trades at the inferior non-displayed bid. As a result, a customer order would trade through a better price that is available to other participants on the same exchange. Unfortunately, the customer will not know that such better price exists and in fact will not have access to this better, private market. This would seem to be at odds with Section 6(b) of the Exchange Act,¹ and with Section 6(b)(5) of the Act,² in that it is not 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, and, in general to protect investors and the public interest.

¹ 15 U.S.C. 78f(b).

² 15 U.S.C. 78f(b)(5).

On the contrary, this aspect of the proposal seems to encourage selective price improvement for those who submit Directed Orders, and enables Directed Orders to trade through better-priced non-displayed markets, all in contravention of the fundamental tenets of the Exchange Act, *i.e.*, just and equitable principles of trade and investor protection. NASDAQ requests that the consistency of this aspect of the BATS proposal with the Exchange Act be explained and clarified, either by BATS itself or by the Commission in any approval order that might be issued.

Restricting Equal Ability to Create Dark Markets

Secondly, under the BATS proposal, only BATS Options Market Makers may enter Market Maker Price Improving Orders, which are accompanied by a non-displayed, or “dark,” improved price. Other BATS Options Member may only submit equivalent Price-Improving Orders with an accompanying dark price in certain instances. Therefore, it is not accurate to say that all options participants are treated equally.

Options Members cannot enter dark interest on equal footing with Market Maker Price Improving Orders unless the dark interest is inside of the allowable quoting increment for an option, a restriction not in place when a Market Maker Price Improving Order posts accompanying dark interest. For example, in a penny option where the NBBO is \$1.05 x \$1.08, a Market Maker Price Improving order could be entered at \$1.05 with a dark bid of \$1.06. No other non-Market Maker Options Member is allowed to enter a Price Improving Order that is not a Market Maker Price Improving Order with an accompanying dark price of \$1.06. Any such interest would be displayed at \$1.06. Accordingly, we believe this is inconsistent with the principle of fair competition at dark prices. In this example, there is no competition at the dark price point because only Market Makers have the ability to provide non-displayed liquidity at these price points. NASDAQ requests clarification as to how this aspect of the BATS proposal is consistent with the Exchange Act, specifically how this aspect is designed to “remove impediments to and perfect the mechanism of a free and open market and a national market system,” as required under the Exchange Act.

Offering a 100% Internalization Program

Lastly, the BATS filing will also provide the ability for BATS Options Members to internalize 100% of their order flow in certain circumstances by way of the use of Directed Orders. Proposed BATS Rule 21.1(d)(14), defines Directed Orders as orders from a BATS Options Member that are directed for execution to a particular BATS Options Market Maker.

In a non-penny option, where quotes are submitted in increments of \$0.05 for options trading up to \$3.00, and in increments of \$0.10 for options trading over \$3.00, a BATS Market Maker can guarantee 100% internalization by entering a Market Maker Price Improving Order at the best bid with a non-displayed component of one additional quoting increment. This ensures that no other participant has a Price Improving Order with a better price and that any order

Directed to that Market Maker will trade fully against that Market Maker. No other participant would have the opportunity to trade against such interest. The BATS Market Maker has established a private market at this price where the BATS Market Maker is guaranteed that any trade is with a member of a select set of participants. In essence, this functionality, if approved, would enable all market makers to operate separate private markets that would only be available to an exclusive list of customers which appears to compromise a free and open market by denying access to the best prices to all but select participants.

For example, in a non penny option where the NBBO is \$2.00 x \$2.40, a participant who wants to bid above \$2.00 up to \$2.04 would be displayed at \$2.00. However, a Market Maker who receives Directed Orders can enter a Market Maker Price Improving Order with a bid of \$2.00 and a non-displayed bid of \$2.05. That Market Maker is now guaranteed 100% internalization with any orders directed to them. This same principle applies in penny options where a BATS Market Maker can be certain that no better priced non-displayed orders exist which would interfere with 100% internalization.

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For these reasons, NASDAQ urges that BATS clarify its proposal to answer these questions, or that the Commission answer them in any order approving the BATS proposal, so that NASDAQ may understand the BATS proposal with sufficient clarity that NASDAQ can, if it chooses, emulate those novel features confident that they comply with the Exchange Act.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Thomas A. Wittman", with a long horizontal flourish extending to the right.

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