Janet L. McGinness
Senior Vice President – Legal & Corporate Secretary
Legal & Government Affairs

20 Broad Street
New York, New York 10005
t 212.656.2039 | f 212.656.8101
jmcginness@nyx.com

VIA EMAIL AND FEDERAL EXPRESS

April 21, 2011

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

Re: Release No. 34-64132 – File No. SR-BATS-2011-009

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 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] We previously expressed concerns regarding BATS' original Directed Order Program rule filing on which this Proposal is based, and despite the changes made to that rule filing in this Proposal, continue to have serious objections to it.[2] In particular, we are very concerned that the Proposal may result in customers receiving inferior executions. In addition, we continue to believe that the Directed Order Program would foster excessive internalization with the strong potential for unfair discrimination between different categories of market participants. Further, we continue to believe that the Proposal is inconsistent with established principles within the options industry regarding participation guarantees. For these reasons, and as discussed more fully below, we believe that the

---

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* letter dated December 28, 2010 from Janet L. McGinness, SVP & Corporate Secretary, Legal & Government Affairs, NYSE Euronext ("December 2010 Letter") to Elizabeth M. Murphy, Secretary, Commission. That letter commented on the BATS rule filing SR-BATS-2010-034, which was subsequently withdrawn by BATS. *See* Securities Exchange Act Release No. 63403 (December 1, 2010), 75 FR 76059 (December 7, 2010) (SR-BATS-2010-034).

Proposal is inconsistent with the Securities Exchange Act of 1934 ("Exchange Act"), and accordingly, strongly urge the Commission to disapprove the Proposal in its current form.

Background

Under the proposed Directed Order Program, BATS Options Members would be able to direct an order to a particular BATS Options Market Maker for potential execution. This would be accomplished through the use of two new order types, a Market Maker Price Improving Order ("MMPIO") and a Directed Order.

An MMPIO would be an order from a BATS Options Market Maker to buy or sell an option that has a displayed price and size and a non-displayed price at which the market maker is willing to trade with a Directed Order. An MMPIO would be ranked on the BATS Options Book at its displayed price; the non-displayed price of the MMPIO would not be entered into the BATS Options Book, but would, along with its displayed size, be 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.

A Directed Order would be an order from a BATS Options Member that is directed for execution to a particular BATS Options Market Maker. For a market maker to participate in an execution against a Directed Order: (1) the Directed Order must be from a BATS Options Member that is on a list of eligible Options Members provided to BATS by the BATS Options Market Maker, (2) the BATS Options Market Maker must be publicly quoting on BATS at the National Best Bid (for sell Directed Orders) or National Best Offer (for buy Directed Orders) (together the "NBBO") with an MMPIO that contains a non-displayed amount of price improvement over the NBBO at the time the Directed Order arrives at BATS, and (3) the Directed Order must be marketable against the non-displayed price of the MMPIO.

The Proposal Will Result in Inferior Executions for Customer Orders

Our greatest concern with the Proposal is that it will result in inferior executions for customer orders in the presence of better-priced MMPIO's. For example, assume that Market Maker 1 ("MM1") and Market Maker 2 ("MM2") each agree to receive Directed Orders from the same order flow provider ("OFP"). The National Best Bid is $1.00; MM1 submits an MMPIO displaying a $1.00 bid for 10, with a non-displayed bid of $1.01; MM2 submits an MMPIO displaying a $1.00 bid for 10, with a non-displayed bid of $1.03. The OFP sends a Directed Order to MM1 to sell 10 contracts at $1.00. Our understanding of the Proposal is that MM2's non-displayed MMPIO bid of $1.03 for 10, which represents the best price available for the OFP's customer, *would not be eligible* to interact with the incoming Directed Order directed to MM1 (since MM2's non-displayed price is only activated by receipt of an order directed to MM2).[3] Therefore, the OFP's customer will sell the entirety of the order at $1.01 *despite MM2's explicit willingness to pay $1.03 for the order*. In this scenario, the customer, having

[3] *See* Proposal at 18280-18281.

no idea that multiple dark MMPIO's were available at various prices in the BATS system, did not receive the best possible price. We believe that such a scenario is completely contrary to the open, transparent and competitive marketplace that exchanges provide.

In this regard, in a traditional exchange marketplace, MM1 and MM2 would both be required and incented to display their most aggressive prices in the consolidated order book in order to be able to trade against any incoming customer orders. Similarly, in a competitive electronic auction mechanism such as those currently available for price improvement on multiple options exchanges, MM1 and MM2 would both be incented to provide their most aggressive prices in response to the request-for-quote message that initiates the auction. Either way, the customer would be filled at the best price available from *either* of the two market makers—or any other available order. Under the Proposal, however, this does not happen—the customer does not get filled at the best possible price, but rather at the best price available from the *one* market maker to whom their order happened to have been directed. As MMPIO's are not displayed, under the Proposal it is in fact *impossible* for the OFP to ascertain to which BATS Options Market Maker that OFP's orders should be directed in order to guarantee the best possible price.[4] Given this, it is remarkable that BATS claims their Proposal "enhances the public price discovery process."[5]

Indeed, we find BATS' use of the term "Directed Order" to describe their Proposal to be highly misleading. Industry-standard preferencing and directed-order programs provide increased allocation to the directed order recipient when they are offering the best available price. They do not, and should not be permitted to, allow the directed order recipient to trade against a customer order when that directed order recipient is *not* providing the best price, as is the case in the BATS Proposal. For this reason alone, the BATS Proposal is unprecedented and should be disapproved.

The Proposal Inhibits Price Competition

BATS claims that the Proposal would provide all market participants, including BATS Options Market Makers, with the ability to compete for executions against Directed Orders. For instance, in options classes subject to the penny pilot, BATS claims that "all market participants can effectively compete against non-displayed Market Maker Price Improving Orders simply by improving the NBBO."[6] In practice, we do not believe this will happen, and therefore find this claim misleading.

---

4 This assumes that certain information sharing practices are prohibited under the Proposal. As discussed below, we have concerns that certain problematic information sharing practices may in fact be permitted under the Proposal.

5 *See* Proposal at 18281.

6 *See* Proposal at 18282.

In particular, a BATS Options Member who has not established Directed Order relationships can only improve the NBBO with a *displayed* quote or order to compete for incoming orders, and therefore would be liable to be traded against by all parties and subject to the standard adverse selection risk appropriately incurred by liquidity providers. On the other hand, a BATS Options Market Maker able to interact with Directed Orders can refrain from improving the public NBBO, and instead only has to match the NBBO and submit an un-displayed MMPIO, knowing that only the market maker's carefully-selected counterparties of choice will have the opportunity to interact with it. It seems very misleading to describe this situation as one where all parties can "effectively compete."

Furthermore, in penny pilot classes, we believe that any price improvement offered by MMPIO's will in fact be *de minimis*. Specifically, as we understand the Proposal, there is no reason for any BATS Options Market Maker to ever offer more than $0.01 of price improvement versus the NBBO, since it is impossible for any other non-displayed order, even at a better price, to interact with a Directed Order directed to that market maker. BATS Options Market Makers can therefore simply update their MMPIO's to consistently beat the NBBO by $0.01 at all times when they choose to offer price improvement at all, then rest easy in the knowledge that they will trade up to their full size against any Directed Orders directed to them while never providing more than that $0.01 of price improvement. Unlike the industry-standard auction mechanisms, BATS has effectively devised a mechanism that virtually guarantees customers will receive only the *minimum* possible amount of price improvement, if any.

In options classes not subject to the penny pilot, the situation is very similar. With respect to such options classes, BATS points out that "all members … have the ability to enter Price Improving Orders," and therefore can effectively compete against market makers using MMPIOs.[7] This claim is similarly misleading because the adverse selection issue highlighted above also exists in this situation. In particular, while un-displayed at their best price, such Price Improving Orders can be traded against by all parties, again resulting in an unlevel playing field when compared with MMPIO's only available for execution by selected counterparties.

Due to the NBBO participation requirement referenced above, BATS also claims that "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 Options Members."[8] However, BATS' price/time priority structure substantially weakens this claim. For example, a BATS Options Market Maker could easily choose to never improve a quoted NBBO but simply follow a "me-too" strategy of joining existing large-size markets, where BATS is already on the NBBO, for 10 additional contracts. As the last participant to join a large existing market on a price/time priority exchange, the market maker in question would be unlikely to be filled on the market maker's displayed quote, and would hence be

7 *See* Proposal at 18281.

8 *Id*.

taking very little real risk. However, such a market maker would nonetheless be eligible to submit MMPIO's offering $0.01 price improvement versus the NBBO, and hence be guaranteed a 100% participation rate against midmarket orders from selected order flow providers for up to 10 contracts. As such, NYSE Euronext believes that the Proposal creates the likelihood that BATS Options Market Makers could trade against 100% of a Directed Order without a balancing risk, responsibility or obligation to justify such a benefit, in contravention of longstanding precedent.[9]

<u>The Proposal Provides for *de facto* 100% Internalization</u>

As described above, the Directed Order Program would permit a BATS Options Market Maker to selectively choose the BATS Options Members from which it will accept Directed Orders. For competitive reasons, it is likely that a BATS Options Market Maker would accept Directed Orders from BATS Options Members with which it has an established business relationship (*e.g.*, a broker dealer affiliate of the Market Maker). We believe that this practice would degrade the transparency, high level of competition and deep liquidity that are the cornerstones of the options industry by providing a *de facto* 100% internalization guarantee for midmarket orders. In this respect, the Proposal stands in stark contrast to existing mechanisms that either provide the opportunity for price improvement to all participants – as is currently available on BATS with Price Improving Orders – or subject an order to a transparent auction where market participants compete for executions while also typically limiting any participation entitlements to 40% of the order size.[10]

<u>The Proposal Lacks Specifics on Important Aspects of Prohibited Conduct</u>

The Proposal provides that it would be considered conduct inconsistent with just and equitable principles of trade for a BATS Options Member to notify a BATS Options Market Maker of its intention to submit a Directed Order so that the market maker could adjust its quote, or for a BATS Options Market Maker that learns of an impending Directed Order from an affiliated broker-dealer (or desk within the same broker-dealer) to proactively adjust its quote before receiving the Directed Order.[11] BATS states that it will surveil for such conduct and enforce violations thereof.[12] However, the Proposal does not address whether it would be permissible for a BATS Options Market Maker to share the details of its MMPIOs, whether existing or

---

9 In this regard, we note that BATS is not proposing to impose heightened quoting or monitoring obligations on BATS Options Market Makers in connection with this Proposal.

10 *See, e.g.*, Chapter V, Section 18 of the Boston Options Exchange ("BOX") Rules describing the Price Improvement Period or "PIP."

11 *See* Proposal at 18282.

12 *Id.*

prospective, with an order flow provider (affiliated or otherwise), so that the order flow provider could make routing decisions based on this information.

Conclusion

NYSE Euronext recognizes and supports the Commission's ongoing leadership in reviewing and addressing trading practices that cause harm to the listed options markets. We believe that mechanisms like the proposed BATS Directed Order Program, which are tacitly discriminatory and encourage internalization without transparency, have no place in the options markets and are inconsistent with the Exchange Act. We therefore respectfully urge the Commission to disapprove the Proposal. We would be happy to discuss the Proposal or these comments at any time.

Very truly yours,

Janet L McGinness