June 2, 2011

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

RE: SR-BATS-2011-009

Ms. Murphy:

BATS Exchange, Inc. ("BATS") is responding to comment letters submitted in response to the above-referenced rule filing ("the Proposal") to establish a directed order program on BATS' options market ("BATS Options"). The Proposal would create two new order types, a Market Maker Price Improving Order and a Directed Order. Under the Proposal, a market maker would have the ability to enter a Market Maker Price Improving Order, which is an order from a market maker that contains both a displayed price and a non-displayed price better than the national best bid or offer ("NBBO") at which the market maker is willing to trade with an order directed to it. To be eligible for execution with a particular market maker, the Proposal would require that the member sending the Directed Order be on a list of firms provided to BATS Options from whom the particular market maker has indicated it will accept Directed Orders. And, the Proposal would require that the market maker to whom the Directed Order is directed is quoting a Market Maker Price Improving Order with a displayed price equal to the NBB or NBO at the time the Directed Order is entered onto BATS Options. In all cases the Proposal would require Market Maker Price Improving Orders 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 Market Maker Price Improving Order, regardless of time priority.

The purpose of the Proposal is to create a directed order program that enhances opportunities available in the market for members to obtain price improvement for customer orders in the context of BATS Options' price/time priority, continuous auction market. As noted in the Proposal:

> "By requiring BATS Options Market Makers to be quoting at the NBB or NBO to participate in an execution against a Directed Order directed to it, BATS' proposal incentivizes market makers to competitively quote and thereby furthers the public price discovery process. By further requiring BATS Options Market Makers to include a non-displayed price better than the displayed limit price at an increment as small as (1) one cent, the proposal increases the opportunities for customer orders to receive price improvement over the NBBO. Moreover, by permitting all Options Members to enter orders in the same increments as Market

> Maker Price Improving Orders, and according those orders in all cases priority at their non-displayed prices over Market Maker Price Improving Orders, the proposal avoids creating participation guarantees in place at other markets and instead promotes market-wide competition for executions at prices between the NBBO."

Commenters to the Proposal have focused their comments around three primary criticisms or concerns as it relates to the structure of the Proposal. Some commenters question whether the proposal actually incents or impedes the public price discovery process. They state that it is anti-competitive and fosters internalization.[1] Some commenters object to the proposal on the grounds that there is a lack of competition at non-displayed prices and that there is no assurance that directed orders would be executed at the best price available.[2] Other commenters note that the structure of the Proposal would create a two-tiered market.[3] BATS believes that the basis for these and the other objections to its Proposal are misplaced or groundless.

Competition, Price Discovery and the Possibility for Excessive Internalization

In its comment letter, the ISE notes, accurately, that "the options exchanges have implemented various programs that give market makers greater allocations based on undertaking additional quoting obligations, [and] 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."[4] Under the Proposal, in order to receive a Directed Order on BATS Options, a market maker would be required to be quoting a displayed price that is equal to the

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1 See Letter from Anthony D. McCormick, Chief Executive Officer, Boston Options Exchange Group, LLC ("BOX"), to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated March 29, 2011 ("BOX Letter"); Kurt Eckert, Principal, Wolverine Trading, LLC ("Wolverine"), to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated April 21, 2011 ("Wolverine Letter"); Michael Simon, Secretary, International Securities Exchange, LLC ("ISE"), to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated April 21, 2011 ("ISE Letter"); Tom Whitman, President, NASDAQ OMX PHLX, Inc. ("PHLX") and The NASDAQ Options Market (taken together, "NASDAQ"), to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated April 21, 2011 ("NASDAQ Letter"); Janet L. McGinness, Senior Vice President & Corporate Secretary, Legal and Government Affairs, NYSE Euronext ("NYSE"), to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated April 21, 2011 ("NYSE Letter"); Andrew Stevens, Legal Counsel, IMC Financial Markets ("IMC"), to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated April 21, 2011 ("IMC Letter"); John C. Nagel, Managing Director and General Counsel, Asset Management and Markets, Citadel LLC, ("Citadel"), to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated April 25, 2011 ("Citadel Letter"); Angelo Evangelou, Assistant General Counsel, Legal Division, Chicago Board Options Exchange, ("CBOE"), to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated April 27, 2011 ("CBOE Letter").

2 See BOX Letter; ISE Letter; NYSE Letter; IMC Letter; CBOE Letter.

3 See ISE Letter; NYSE Letter; IMC Letter; CBOE Letter.

4 See ISE Letter.

NBB or NBO. This displayed price and size would be available and at risk to all members of the exchange.

This is a strong requirement and one that will not lightly or easily be met by market makers wishing to receive directed orders. 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. Citadel points out that, "Sending quotes accessible to all market participants is much riskier and less profitable than sending quotes accessible to only approved market participants."[5] When advocating the position that non-MMPIO sending firms are at a competitive disadvantage to MMPIO submitting firms, the ISE states, "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."[6] (Emphasis added). The NYSE similarly notes that options members without Directed Order relationships must compete with displayed quotes or orders that are "liable to be traded against by all parties and subject to the standard adverse selection risk appropriately incurred by liquidity providers."[7] This is exactly the point that BATS is making in the structure of its directed order program – a structure that is lacking from the ISE's, the NYSE's and the other exchanges' directed order programs. 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"[8] or "encourage internalization

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5 See Citadel Letter.

6 See ISE Letter.

7 See NYSE Letter.

8 See ISE Letter.

without transparency,"[9] the Proposal would foster efficient competition by placing all firms on a more level playing field and incenting effective competition through price.

Possibility of Inferior Executions, Handling of Multiple MMPIOs

Several members raise the concern that because of the possibility of multiple non-displayed orders at differing levels within the NBBO, there exists the possibility under BATS proposal for inferior executions for customer orders. The NYSE presents the following scenario:

> 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).[10]

The NYSE's description and understanding of the BATS proposal is a scenario that could play out exactly as described. For clarity, BATS has graphically demonstrated the NYSE's example, with the inclusion of additional participants. In the scenario above, OFP has made the decision, based on the nature of its order that MM1 is the market maker that will provide the best execution for its order. In this scenario, although MM2 would be willing to trade with directed orders from MM1 at a more aggressive price, that price is conditioned on MM2 being preferenced by OFP. A similar scenario would play out below if OFP made the decision to direct their order to MM0, a market maker who also has an established Directed Order relationship with OFP. MM0, while on the NBBO, has not committed any price improvement toward directed orders. In this case, the conditional prices neither MM1 nor MM2 are triggered and the order will execute with resting prices on the book at \$1.00. Similar to the way in which the structure of the Proposal empowers the maker makers to select which firms they wish to commit price improvement to, the Proposal also empowers order flow providers to select which market making firms they wish to preference.

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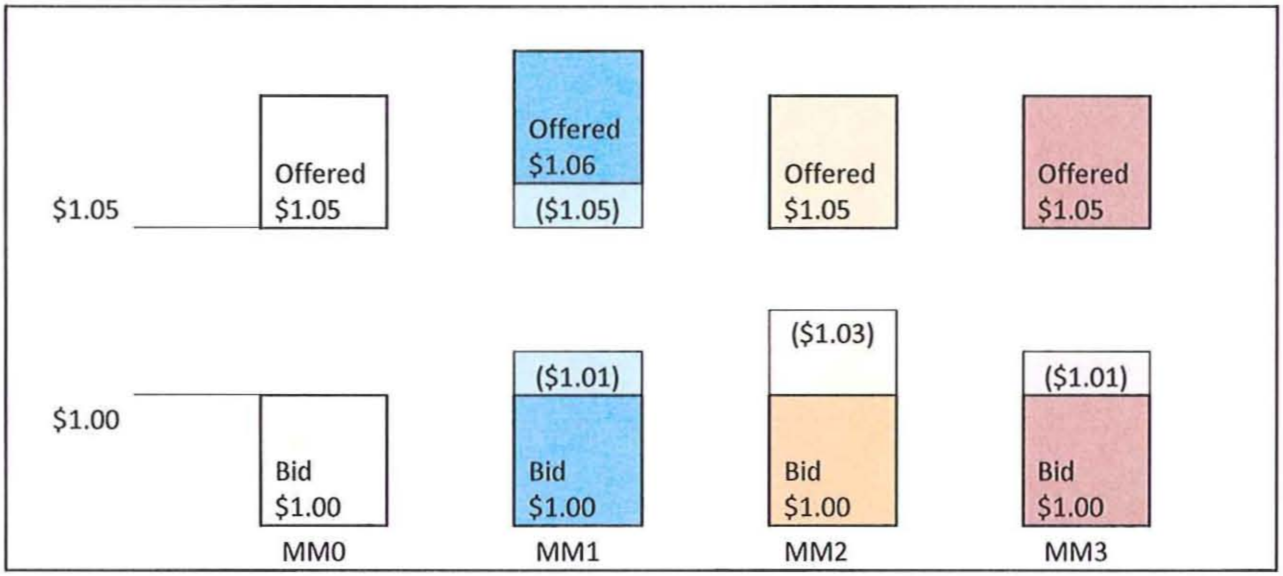
9 See NYSE Letter.

10 See NYSE Letter.



This important advantage in the structure of the Proposal was previously noted by commenters to the first version of this proposal and remains integral to its structure.

> ... the proposed rule changes are similar in nature to the price improvement auctions that currently exist in the market with one significant difference which allows the ability for a firm to direct orders to a market participant. TD Ameritrade strongly supports this approach as it provides firms with competitive opportunities to seek price improvement on client option orders. [11]

Similarly, as it relates to the possibility that, "a customer order would trade through a better price that is available to other participants on the same exchange." [12] BATS contends that there is no possibility for a trade-through when the conditional price improving prices are not actually available – by their very nature, they are conditional. If a firm enters an order and trades with MM0 at $1.00, in price-time priority, they have not traded through $1.01 and $1.03 prices. Rather, there are no $1.01 nor $1.03 prices available. Those prices exist on the BATS Options book only when the various market makers receive Directed Orders from their approved participants.

One issue raised by some commenters meriting further consideration is the question that arises when an OFP has relationships with multiple market makers and wishes to direct an order to multiple market makers. As originally conceived, the Proposal would have limited an OFP to the selection of a single market maker to whom to direct a particular order. Upon further consideration of the issue, however, BATS has determined to amend the Proposal to make clear that an OFP can elect to direct an order to multiple market makers, such that it will execute

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11 See Letter from Christopher Nagy, Managing Director Order Strategy, TD Ameritrade, Inc ("Ameritrade"), to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated December 23rd, 2011.

12 See NASDAQ Letter.

against the market maker with the best conditional price. Referring back to the NYSE scenario described above, if the if OFP were to direct and order to MM1 and MM2, MM2 would receive priority and execute at $1.03 with remaining interest being directed to MM1 at $1.01, then the order book at $1.00, in line with the general and overall price-time priority nature of the BATS Options. BATS believes this proposed modification more accurately reflects the reality of the multiple relationships today between OFPs and market makers, and would have the effect of further enhancing the competitive quoting the Proposal is designed to foster.

Finally, as it relates to any other suggestion that directed orders, or any other order for that matter, would be subject to inferior execution on the BATS Options platform under the Proposal, the nature of the BATS Options market structure simply does not warrant such concern. In all cases, prior to the implementation of the Proposal, and after its approval, the structure of BATS Options' is one of a price/time priority market. The nature of price/time priority markets is that the best price is always rewarded with priority allocation. This proposal reinforces the primacy of best price, and does not diminish or alter it in any way.

Creates a Cap on Price Improvement

Some commenters suggest that by allowing market makers to enter price improving orders in increments as small as $.01, this somehow creates an artificial cap or limits the ability for orders to receive price improvement[13]. This argument is meritless. Nowhere in the Proposal does BATS suggest a *maximum* amount of price improvement. Rather, the proposal requires a *minimum* amount of price improvement. Further, we note that by requiring a minimum level of price improvement the structure of the Proposal is stronger in its protection of client interests than the directed order structures currently in place at competing exchanges. As can be seen in the illustration above, where multiple market makers are competing for directed orders, some with prices that are *more than $.01* better than the NBBO, there is nothing in the wording of the rule, nor the competitive forces created by a price-time priority market that would cap the price improvement opportunities available to order flow providers.

Creation of Two-Tiered Markets and Restricting Equal Ability to Create Dark Markets

Multiple commenters take issue with the unequal treatment of Directed Order sending firms and MMPIO entering firms. It is true that under the Proposal, the firms permissioned by market makers are the only firms capable of accessing the non-displayed price improving prices committed to by those same market makers. It is also true that registered market makers on BATS will be the only members able to enter non-displayed penny prices in penny quoted options. BATS contends that neither of these truths contributes to an unfair, unlevel or non-competitive market.

Certain order flow sending firms today have flow, which by its very nature, is more valuable to some market participants than the flow of other order flow sending firms. With that

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13 See BOX Letter; NYSE Letter.

given, the Proposal puts in place a structure by which *all* members can both compete for that flow – by contributing to price and size discovery for the entire market – and reward that flow with price improvement above and beyond the NBBO.

Framing the discussion of the BATS proposal as one about "dark markets" is a red herring argument. There is no "dark" liquidity created by the proposal, nor is there any restriction of competition. We point out again that what we are doing is incenting the right behavior and the right results. Refer back to the illustration of the $1.00 by $1.05 market above – BATS is putting in place every incentive, from pricing to priority, for members – *for any and all members* – to compete for the orders that would be directed to the illustrated market makers, by the simple mechanism of inserting a bid at $1.01. Yes, this bid would be displayed to the entire market. Yes, it would be accessible and at risk to the entire market – as are all of the participants in the illustration, with orders resting at $1.00. That is the way that an efficient, transparent, and competitive market should work.

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BATS appreciates the opportunity to provide this response to the comments received on BATS Options proposal to establish a directed order program. Please feel free to contact me if you have any questions in connection with this matter.

Sincerely,

Jeromee Johnson