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April 2, 2013

VIA ELECTRONIC SUBMISSION AND OVERNIGHT DELIVERY

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 20549

Re: Release No. 34-69040; File No. SR-BX-2013-016

Dear Ms. Murphy:

NYSE Euronext appreciates the opportunity to comment on the proposed rule change of NASDAQ OMX BX, Inc ("BX") regarding the filing to establish a Directed Order process (the "BX Proposal"). As the operator of two options businesses, NYSE Arca Inc. and NYSE Amex Options LLC, we support efforts to provide investors with improved tools to hedge risk using options. In this instance, however, we feel that the BX proposal as filed is lacking important details and contains elements that raise concerns relating to increased internalization opportunities which could be detrimental to investors and the options marketplace as a whole. NASDAQ OMX BX should address these issues before the Commission considers approving the Proposal.

The BX Proposal Appears to Violate Time Priority

NYSE Euronext believes that the BX Proposal is lacking important details which would clarify whether the Directed Order process could be used to foster internalization beyond the level generally seen as acceptable by the Commission.[1]

Specifically, the Proposal lacks the clarity needed regarding the allocation of a Directed Order in certain situations where the directed market maker is quoting first in time priority at the best price. (BX proposes that Directed Orders will be available when either the Price/Time or the Pro/Rata Execution Algorithm is in effect for a particular option.[2]) The Proposal states (emphasis added),

[1] *See* NYSE MKT Rules 964NY(b)(2)(B), and 964NY(b)(2)(C; CBOE Rules 8.87, 8.15B and 8.13(c), and NASDAQ PHLX Rules 1014(g)(ii)and 1014(g)(viii) which generally limit participation guarantees to the greater of size pro rata or 40%. The Exchange notes that there are exceptions such as the small order, (5-lot), participation entitlement but notes that exchanges with such exceptions are required to monitor the volume executed in that order size range and adjust the size of the participation guarantee as necessary to ensure the ratio of such volume to total volume remains below 40%.

[2] *See* NASDAQ OMX BX Rules, Chapter VI, Section 10, Book Processing.

> "If the option is subject to the Price/Time execution algorithm, the Directed Market Maker shall receive 40% of the Directed Order at a particular price ("Directed Allocation")[3], unless such Directed Market Maker was first in time priority, in which case such Directed Market Maker shall receive the amount of the Directed Order equal to the Directed Market Maker's quote/order size at that price. If there are multiple resting quotes/orders from the same Directed Market Maker, the Directed Allocation will be distributed among them in time sequence."

While we believe the wording is somewhat vague, the underlined text gives rise to internalization concerns. Consider the following scenario wherein a market maker with a very fast system is able to routinely "set price," i.e., to be the first market maker to post a bid or offer at a given price, albeit for small size such as a one-lot. The BX Proposal seems to imply that the time priority for the one lot is then, for purposes of Directed Order allocations, maintained for any and all other interest which the directed market maker may subsequently place in the book at the same price:

Example 1 (Price/Time)

NBBO: $1.00 - $1.05

BX Options Book in time sequence:

- MM1 Quote A $1.00 - $1.05 (size 1 x 1, first in time priority)
- Firm2 Order B Sell 20 at $1.05
- MM3 Quote C $1.00 - $1.05 (size 20 x 20)
- Firm4 Order D Sell 50 at $1.05
- MM1 Order E Sell 19 at $1.05 (last in time priority)

BX Options Best offer: 110 contracts at $1.05

BX receives a Directed Order from an order routing affiliate of MM1 to buy 20 contracts at $1.05, directed to MM1

In this example, the language in the Proposal that a Directed Market Maker "shall receive the amount of the Directed Order equal to the Directed Market Maker's quote/order size at that price" seems to indicate that **all 20 contracts execute against MM1** (1 from their initial quote at $1.05, and 19 from their subsequent order at $1.05), despite the existence of substantial interest with higher time priority than all of MM1's size except the initial one-lot—resulting in a 100% participation guarantee. It therefore seems that a Directed Order allows for interest ranked lower in time priority to jump the

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3 NYSE Euronext notes that granting a Directed Order market maker 40% of the order size as an allocation when they are not first in time priority is seemingly at odds with NASDAQ OMX BX Rules, Chapter VI, Section 10(1)(A) and is likely to cause confusion for investors but this is minor point relative to the other issues raised by this filing.

queue and take priority over other interest in the book as long as some interest, no matter how small, is at the head of the queue in time priority, significantly muddying the behavior of price/time priority. **To remedy this concern, we respectfully suggest that the BX Proposal be modified to clarify that the Directed Market Maker will receive only the size he/she has *at the first position in time priority*, plus up to 40% of the *remainder* of the Directed Order**.

Additional Concerns Arise If Time Priority Violation is Not Addressed

1. Selective Quoting

The BX Proposal does not indicate whether Market Makers will be able to discriminate between order sending firms by specifying the firms from which they will accept Directed Orders, saying only that a Directed Order must be sent "pursuant to the Exchange's instructions on how to direct an order". If a Market Maker is able to restrict itself to receiving directed orders from its own order routing affiliate only, for instance, then in the example above, when trading against a 20-lot order to pay $1.05 from any other participant, MM1 would trade a single contract only. (Indeed, the same would apply to any order up to 91 contracts.)

As a result, due to the combination of this opportunity to discriminate between participants with the time priority issues outlined above, the Proposal would seem to grant MM1 the ability to trade in larger size *only* against his or her own order flow: **MM1 is effectively quoting 20 contracts for affiliated order flow of any size, but is only quoting 1 contract for all other orders smaller than 91 contracts**. NYSE Euronext believes this practice could be at odds with the firm quote rule. Hence the filing should explain in more detail whether directed market makers are obligated to interact with all Directed Orders directed to them, or only with some subset of the directed market maker's choosing.

2. Price Improving Orders

NYSE Euronext also notes that BX currently has rules for Price Improving Orders, which "are orders to buy or sell an option at a specified price at an increment smaller than the minimum price variation in the security. Price Improving Orders may be entered in increments as small as one cent. Price Improving Orders that are available for display shall be displayed at the minimum price variation in that security and shall be rounded up for sell orders and rounded down for buy orders."[4] The BX Proposal is silent as to how Price Improving Orders will be treated for purposes of this Directed Order process. Consider the following example:

Example 2 (Price/Time)

NBBO: $3.00 - $3.15 (option quoted in increments of $0.05 above $3.00)

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4 *See* NASDAQ OMX BX Rules, Chapter VI, Section 1,(e)(6)

BX Options Book in time sequence:

Firm2 Order B Sell 20 at $3.15 (first in time priority)
MM3 Quote C $3.00 - $3.15 (size 20 x 20)
Firm4 Order D Sell 50 at $3.15
MM1 Order E Sell 30 at $3.15 (last in time priority)

If, after this scenario has been established, MM1 sends a new Price Improving Order to sell 1 contract at $3.14 (which will be displayed at $3.15), and BX then receives a Directed Order from an order routing affiliate of MM1 to buy 20 contracts at $3.15 directed to MM1, **will all 20 contracts execute against MM1** (1 against the $3.14 offer displayed at $3.15, and 19 against Order E)?

NYSE Euronext believes that such treatment would lead to greatly increased levels of internalization to the detriment of the marketplace as a whole, particularly since dark interest could be used to establish time priority for a de minimis size, to which greater size at a worse price could be added for allocation purposes, even if there were other participants ahead of the directed market maker in time priority at the worse price.

3. Order Routing Systems and Opportunities for 100% Internalization

NYSE Euronext has additional concerns relating to the notion of a Directed Order in the context of a price/time allocation model, particularly given the communications that are permitted between the market making function of a broker-dealer and other divisions, such as an order sending affiliate. For instance, BX rules relating to Information Barriers state (emphasis added),

> "The market making functions are conducted in a physical location separate from the locations in which the Other Business Activities are conducted, in a manner that effectively impedes the free flow of communications between designated representatives of an Options Participant performing the function of a Market Maker and persons conducting the Other Business Activities. However, upon request and not on his own initiative, a designated representative of an Options Participant performing the function of a Market Maker may furnish to a person performing the function of an OEF or other persons at the same firm or an affiliated firm ("affiliated persons"), the same market or trading information, so long as the Market Maker also may make available such information to non-affiliated persons with whom the Market Maker may have the same type of business relationship. The designated representative of a Market Maker must provide such information to affiliated persons in the same manner that he would make such information available to a non-affiliated person."[5]

NYSE Euronext believes such language may permit the Market Maker to simultaneously stream their quotes to both the exchange (in this case BX) and, through one-way communication, to their affiliate (in this case, their order routing division, which BX refers to as an Order Execution Firm or "OEF"). With this

[5] *See* NASDAQ OMX BX Rules, Chapter VII, Section 10(b).

information, the OEF can ascertain whether their market making affiliate is the first participant to quote at a given price on BX by comparing the updates to the BX BBO with the quotes and orders they have received from their market making affiliate. To be clear, NYSE Euronext has no objection to this practice subject to established exposure requirements and internalization limits that currently exist on all markets. However, given that it appears the BX Proposal will aggregate all of a market maker's interest at a price to grant them time priority for the entire size of their quote, the combined impact of these Rules will be that every time an OEF's market making affiliate is first to quote at a given price, **the OEF will be able to internalize 100% of an order, up to the market maker's entire size at that price, even when the initial quote that established time priority is for a single contract, to the detriment of other market makers with time priority**.

The BX Proposal Grants a Preferential Allocation to Directed Market Makers Quoting Outside the NBBO

Finally, NYSE Euronext has significant concerns about language in the BX Proposal that breaks new ground by granting a participation guarantee to a market maker who is quoting outside the NBBO. The BX Proposal states (emphasis added):

> "If the option is subject to the Price/Time execution algorithm, the Directed Market Maker shall receive 40% of the Directed Order at a particular price ("Directed Allocation"), unless such Directed Market Maker was first in time priority, in which case such Directed Market Maker shall receive the amount of the Directed Order equal to the Directed Market Maker's quote/order size at that price. If there are multiple resting quotes/orders from the same Directed Market Maker, the Directed Allocation will be distributed among them in time sequence."

NYSE Euronext notes that no exclusions are given to the 40% allocation "at a particular price," and hence the Directed Market Maker would *always* receive a 40% allocation at any price, including prices that are not at the top of the book and including in cases where the Directed Market Maker did not have a quote at the NBBO at the time that the order was received by the Exchange. This is an unprecedented development and one regarding which NYSE Euronext has serious concerns. To date, the Commission has granted the increased reward of a preferential Directed Order allocation only to Market Makers who are taking the commensurate risk of quoting at the NBBO, and appropriately so: posting firm quotes accessible by all participants at the NBBO is a benefit to all participants in that it fosters price discovery and transparency. The BX Proposal expands participation guarantees to directed market maker participants who do not have a quote at the NBBO at the time the order is received. Indeed, it appears that BX Market Makers will be able to lay in wait outside the NBBO, allowing other participants to participate in the order at less attractive prices and then receiving a 40% guarantee for that portion of the Directed Order that trades at more attractive prices (from the Market Maker's standpoint) beyond the initial NBBO. NYSE Euronext believes that this practice would be detrimental to transparency and price discovery by destroying incentives for Market Makers to quote aggressively at the NBBO.

The BX Proposal states that "quoting a tick or two away from the NBBO is likely to result in very little trading for that market maker, especially if other quotes and orders are at or closer to the NBBO and especially in more liquid options." If this is true, then there should be no harm to either NASDAQ OMX BX or NASDAQ OMX BX Options Market Makers in simply addressing this concern by imposing an NBBO participation requirement in order to received an enhanced allocation from Directed Orders, consistent with the requirement appropriately imposed by other exchanges in the past under rules approved by the Commission. **To remedy this concern, we recommend that BX stipulate that a preferential Directed Order allocation of any kind is only available to Market Makers who have a quote or order at the NBBO at the time the Directed Order is received by the Exchange.**

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In summary, NYSE Euronext believes that the Proposal may result in de facto participation guarantees well in excess of the 40% level that has served the industry well in terms of striking the right balance between risk (transparently quoting at the NBBO) and reward (opportunity to garner an enhanced allocation to a trade). Removal of sufficient order flow via 100% internalization will reduce trading opportunities for other participants. Such a reduction in the opportunity to trade at the NBBO is detrimental to investors and the NMS system as a whole. NASDAQ OMX BX should amend its filing to clarify that the internalization opportunities we have described in this letter will not be made possible by their proposed mechanism.

We appreciate the Commission's consideration of our comments. If the Commission or its Staff has any questions, please feel free to contact Mr. Mike Babel, at (212) 656-4744.

Sincerely,

Janet McGinness