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NYSE EURONEXT

VIA ELECTRONIC SUBMISSION AND OVERNIGHT DELIVERY

May 10, 2013

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

Re: File No. SR-BX-2013-16

Dear Ms. Murphy,

NYSE Euronext ("NYSE") appreciates the opportunity to provide additional comments on the proposed rule change of Nasdaq OMX BX, Inc. ("BX") to adopt a Directed Order process.[1] We originally submitted a comment letter on April 2, 2013, focusing on our concern that the Proposal permitted 100% internalization and potentially reduced trading opportunities for other participants in the options marketplace. While we appreciate BX's response to that comment letter, we believe that their response is inadequate because our concerns regarding two issues persist: the BX Proposal would (1) disincentivize the public price discovery process because it permits market makers to obtain priority while quoting away from the NBBO and (2) permit Directed Allocations to a market maker that enters a quote after a public customer order eligible to trade with a subsequent Directed Order. Both of these issues are inconsistent with the purposes of the Exchange Act.

I. BX's Proposal Would Hinder the Public Price Discovery Process and Decrease the Incentive to Quote Competitively

Under Proposed Section 10(3)(iii), where a Directed Market Maker's quote is not at the NBBO, BX would still permit the Directed Allocation to the Directed Market Maker at the next price level after the NBBO is cleared. BX acknowledges that the purpose of the requirement for the directed participant to be at the NBBO "is to encourage such participant to quote competitively rather than to quote a wide market and wait for directed orders to arise." The effect of the Proposal will likely be just the opposite: by rewarding market makers whose quotes are not the most aggressive, it will encourage market makers to quote away from the inside market. In doing so, the proposal presents systemic concerns that are even more troubling than those held by the Commission and staff for more than a decade about the tendency of passive price matching behavior to degrade price competition in the options market.[2] Indeed, the

[1] *See* Securities Exchange Act Release 69040 (Mar. 5, 2013), 78 FR 15385 (Mar. 11, 2013) (SR-BX-2013-016) ("BX Proposal").

[2] *See* Special Study: Payment for Order Flow and Internalization in the Options Markets, Office of Compliance Inspections and Examinations and Office of Economic Analysis (Dec. 2000) ("Further, the Commission recently

proposal would not even require passive price matching as a requirement for an allocation. The Exchange believes that such incentives, if approved and adopted broadly, would deteriorate rather than enhance incentives of market makers to compete for incoming orders based on price.

BX stated that, even though the Directed Market Maker would receive priority away from the NBBO, the market maker still has an incentive to quote competitively because if the Directed Market Maker does not quote competitively, the Directed Market Maker is not likely to receive an execution.[3] In our previous comment letter, we objected to BX's rewarding Directed Market Maker's who quote away from the NBBO as disrupting the public price discovery process. BX responded that requiring the Directed Market Maker's quote be at the NBBO *at the time of execution* would foster price discovery and transparency.[4] Despite BX's response, the fact remains that the proposal relaxes what is currently required for directed allocations, and can only serve to undermine, rather than enhance, the incentive to quote aggressively.

In approving rule proposals that guarantee an allocation to a market maker, the Commission has consistently focused on two distinct aspects of the proposals: (1) the market maker's quote is equal to the NBBO at the time of receipt of the order, and (2) public customers receive priority.[5] As discussed above, BX's Proposal ignores the first requirement, and as shown below, implements the opposite of the second.

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expressed its concern that payment for order flow and internalization contribute to an environment in which quote competition is not always rewarded, thereby discouraging the display of aggressively priced quotes. In the multiple trading environment, specialists on the competing options exchanges typically will promise to match the displayed prices of other exchanges. If widespread, these passive "price matching" practices may weaken the incentive to display competitive quotes, because displaying a superior quote does not necessarily ensure attracting additional order flow. Over time, therefore, the quotes being matched may become wider, increasing execution costs to investors. By some measures, the improvements in quoted prices experienced after increased multiple-listing in August 1999 have been muted coincident with the increasing prevalence of payment for order flow and internalization."); Securities Exchange Act Release No. 61902 (Apr. 14, 2010) ("The Commission further acknowledges the broader concern that payment for order flow may result in less aggressive competition for order flow on the basis of price, such as through displaying aggressively-priced quotations or offering opportunities for price improvement."); *see also* Securities Exchange Act Release No. 49175 (Feb. 3, 2004), 69 FR 6124, 6130 (Feb. 9, 2004) ("Competitive Developments in the Options Marketplace") ("Rule or practices that permit or encourage internalization may also reduce intramarket price competition and, therefore, cause spreads to widen.")

[3] BX Proposal at 15389.

[4] It is unclear from BX's Proposal whether a Directed Market Maker quote has to be one tick away from the NBBO or whether the quote simply has to be at BX's BBO. The Proposal seems to indicate that as long as the Directed Market Maker's quote is at BX's BBO, then it does not matter how far away that price is from the NBBO. If this is in fact the case, the undermining of the incentive to quote aggressively could be even more pronounced, in that a quote significantly away from the inside market would be rewarded even though it is plainly not competitive on price.

[5] *See* Securities Exchange Act Release 51818 (June 10, 2005), 70 FR 35146, 35149-50 (June 16, 2005) ("The Commission has previously approved rules that guarantee a Primary Market Maker a portion of each order when the Primary Market Maker's quote is equal to the NBBO . . . . [A] Preferred Market Maker will have to be quoting at the NBBO at the time the Preferenced Order is received to capitalize on the participation guarantee. The Commission believes it is critical that the Preferred Market Maker cannot step up and match the NBBO after it receives an order, but must be publicly quoting at that price when the order is received."); Securities Exchange Act Release 42808 (May 22, 2000), 65 FR 34515, 34517 (May 30, 2000) ("Although the Commission recognizes that intramarket competition, as well as protection of public customers, could be compromised if such a participation

II. BX's Proposal Would Not Respect Public Customers and Further Disincentivize the Submission of Displayed Liquidity

The options markets have had a longstanding distinction between a public customer and a professional, in which marketplace advantages are provided to public customers in order to level the playing field between retail investors and market professionals. The Commission has previously approved the preferential treatment to public customers, and even preferential treatment to only less-sophisticated public customers.[6] However, the BX Proposal is attempting to turn the distinction on its head and provide preferential treatment, not to public customers, but instead to the sophisticated professionals.

Pursuant to the Proposal, a Directed Market Maker, even when not first-in-time, would be permitted to receive a Directed Allocation before any public customer orders. When an option is subject to the Price/Time execution algorithm, the BX Proposal permits a Directed Allocation to a Directed Market Maker, even though public customer orders are at the same price level. Unlike the restriction found in Section 10(3)(i)(B)—applicable to options subject to the Pro-Rata execution algorithm—providing for the execution of public customer limit orders before any Directed Allocation, Section 10(3)(i)(A) contains no such restriction.[7] As a result, and as BX's Example 1A makes clear, a later arriving Directed Market Maker Quote, which merely passively price matches a public customer's order, would be permitted to receive a 40% allocation before the public customer receives an allocation. Therefore, BX would allow a Directed Market Maker to arrive after a public customer who has aggressively improved the NBBO, and permit that Directed Market Maker to receive a partial execution for an order that could have potentially completely filled the public customer's order. Based on rules and examples that BX has provided, consider the following example:

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right constituted an absolute guarantee or if it consumed too great a percentage of order flow, the Commission believes that the ISE's proposal sets forth reasonable safeguards against such potential harms. The ISE's proposal prioritizes public customer limit orders on the book. Indeed, if sufficient existing customer interest exists a PMM might not receive any allocation of a given incoming order . . . . The Commission believes that these limits on a PMM's participation right should assure reasonable protection for public customers and prevent impediments to a free and open market that might otherwise result from an absolute specialist guarantee.").

[6] *See* Securities Exchange Act Release No. 59287 (Jan. 23, 2009), 74 FR 5694, 5700 (Jan. 30, 2009) ("[T]he Commission does not believe that the current rules of ISE and other exchanges that accord priority to all public customers over broker-dealers and market makers are unfairly discriminatory. Nor does the Commission believe that it is unfairly discriminatory to accord priority to only those customers who on average do not place more than one order per minute as ISE proposes.").

[7] In creating the National Market System, Congress deemed that "[i]t is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . an opportunity . . . for investors' orders to be executed without the participation of a dealer." *See* 15 U.S.C. § 78k-1(a)(1)(C)(v). Respecting customer limit orders in terms of priority serves that goal mandated by Congress: requiring Directed Market Makers to yield to public customers' orders would ensure that customer limit orders are more likely to interact with one another without the intervention of a dealer. BX has the ability to undermine that goal by deciding, on an option-by-option basis, whether or not public customers receive priority ahead of Directed Market Makers through its choice of which algorithm is applicable to a particular option.

NBBO: $1.00 x $1.06

MM1 Quote A $1.00 x $1.06 (size 100 x 100)
Firm1 Public Customer Order A Sell at $1.05 for 100
MM1 updates Quote A to $1.00 x $1.05 (size 100 x 100)

BX Options Best Offer: 200 at $1.05

BX receives a Directed Order to buy 100 contracts at $1.05 directed to MM1:

40 contracts execute against MM1 Quote A as a Directed Allocation: 40% of 100 contracts
60 contracts execute against Firm1 Public Customer Order A based on time priority

As a result of the priority provided to the Directed Market Maker, the public customer's order does not receive a full execution of its order. Despite providing an aggressive quote which improved the NBBO, the public customer is not fully rewarded as they would be on other options exchanges. The public customer does not receive the same benefits and the economics of improving the NBBO have shifted, resulting in fewer displayed public customer orders and fewer public customers willing to improve the NBBO. This shift in the economics would be even more exacerbated in thinly traded options since the public customer is even less likely to receive a full execution of its order.

NYSE Euronext believes that the appropriate approach to the priority between customers and Market Makers for Directed Orders is to ensure that customer orders have first priority, especially where customer orders are ranked ahead of market makers' orders. Currently, if there are customer orders ranked ahead of a Lead Market Maker's quote, NYSE Arca Inc. does not award the Lead Market Maker the 40% participation entitlement they would otherwise receive and instead grants strict time priority to the customer, thus ensuring that customers aggressively improving the NBBO are fully rewarded.[8] Additionally, NYSE Amex Options LLC gives priority to customer orders for incoming Directed Orders, even if the market maker has time priority.[9] Both of these approaches incentivize a public customer willing to aggressively quote, ensuring that those investors who improve the NBBO are properly and fully rewarded. On the other hand, BX's Proposal would decrease the incentive to improve the NBBO by allowing Directed Market Makers to passively "price match" a public customer order and still receive a 40% allocation.

III. Conclusion

As explained above, NYSE Euronext believes the BX Proposal would inhibit the public price discovery process and lessen the incentive to publicly display orders. Even more concerning, the Proposal would put public customers at a disadvantage to sophisticated market

[8] *See* NYSE Arca Options Rule 6.76A.

[9] *See* NYSE MKT Rule 964NY.

makers. In light of these concerns, we believe that the Commission should disapprove the BX Proposal.

We appreciate the Commission's consideration of our comments. If the Commission or its Staff has any questions please feel free to contact me at 212-656-2039.

Sincerely,

Janet McGinness

cc: Heather Seidel, Associate Director, Division of Trading and Markets