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NYSE EURONEXT

VIA ELECTRONIC SUBMISSION AND OVERNIGHT DELIVERY

July 15, 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 in connection with the above-referenced Nasdaq OMX BX, Inc. ("BX") proposal to establish a Directed Order process[1] and to respond to the Securities and Exchange Commission's (the "SEC's" or the "Commission's") Order Instituting Proceedings to Determine Whether to Disapprove the Proposed Rule Change.[2] NYSE submitted two comment letters in response to the BX Proposal. In its first letter, dated April 2, 2013, NYSE expressed its concern that the BX Proposal permitted 100 percent internalization of orders and potentially reduced trading opportunities for other participants in the options marketplace.[3] NYSE's second comment letter, dated May 10, 2013, focused on the BX Proposal's potential (1) to disincentivize the public price discovery process and (2) to permit a Directed Allocation to a market maker ahead of prior-arriving public customer orders.[4] NYSE believes that BX has failed to address properly the concerns raised by NYSE's comment letters and reflected in the Commission's Order Instituting Proceedings and therefore believes that the Commission should disapprove the BX Proposal.

## I. BX Has Failed to Explain How the Proposal Would Not Hinder the Public Price Discovery Process and Decrease the Incentive to Quote Competitively

In the Order Instituting Proceedings, the Commission raised questions as to "whether, and if so how, the proposed rules could impact quote competition on the Exchange."[5] NYSE discussed in its previous comment letters how the BX Proposal reduces a Directed Market

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

[2] *See* Securities Exchange Act Release No. 69684 (June 3, 2013) ("Order Instituting Proceedings").

[3] *See* Letter to the Commission from Janet McGinness, Executive Vice President, Secretary and General Counsel, NYSE Euronext, dated April 2, 2013 ("NYSE Letter").

[4] *See* Letter to the Commission from Janet McGinness, Executive Vice President, Secretary and General Counsel, NYSE Euronext, dated May 10, 2013 ("NYSE Response Letter").

[5] *See* Order Instituting Proceedings at 11.

Maker's incentives to match or aggressively price improve the National Best Bid or Offer ("NBBO"). Specifically, the Directed Market Maker could receive Directed Allocations even when not quoting at the NBBO. The Commission has historically linked the requirement that a market maker quote at the NBBO when a Directed Order arrives with the benefit of receiving a Directed Allocation,[6] and NYSE believes that decoupling this benefit/burden relationship would have adverse effects on the market.[7]

BX states that the public price discovery process is "improved by deep markets and does not require or anticipate that every market maker should quote on the NBBO at all times."[8] While BX is correct that increasing market depth is an important aspect of the public price discovery mechanism, BX fails to acknowledge that the increase in market depth would be at the expense of having fewer Directed Market Makers quoting at the NBBO. As NYSE previously stated, the BX Proposal would relax current requirements for Directed Allocations, namely the requirement to quote at the NBBO, which would only serve to undermine, rather than enhance, the incentive to quote aggressively. Consider the following examples:

<u>Directed Order Process on NYSE Amex Options:</u>

NBBO: $1.00 - $1.05 (100 x 150)

Firm 1 enters Order A Sell 50 at $1.05
Firm 2 enters Order B Sell 200 at $1.06
Firm 3 enters Order C Sell 200 at $1.06
MM1 enters Quote D: $1.00 - $1.05 (size 100 x 100)

Incoming Buy Directed Order to MM1 for 300.

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[6] *See* Securities Exchange Act Release No. 51818 (Jun. 10, 2005), 70 FR 35146, 35149-50 (Jun. 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.") (emphasis added).

[7] The Exchange notes that in addition to allowing Directed Market Makers to quote away from the NBBO and still receive Directed Allocations, the BX Proposal would relax the heightened quoting obligations imposed on Directed Market Makers. Directed Market Makers would be subject to heightened quoting obligations for the remainder of the month only upon receiving a Directed Order, further disrupting the balance of benefits and burdens previously approved by the Commission.

[8] *See* Letter to the Commission from Edith Hallahan, Principal Associate General Counsel, Nasdaq OMX BX, dated July 1, 2013 ("BX Letter"), at 2.

Under NYSE Amex Options rules, a market maker must quote at the NBBO to receive a Directed Allocation. Based on the above scenario, an incoming buy Directed Order to MM1 for 300 would execute against MM1's Quote for 100 at $1.05,[9] then against Firm 1's Order for 50 at $1.05. Firms 2 and 3 would receive a size pro rata allocation of 75 contracts each.[10] If MM1 did not quote at the NBBO, as required by NYSE MKT Rules, and instead quoted at $1.06, MM1 would not be permitted to receive the guaranteed allocation. MM1, as well as Firms 2 and 3, would instead receive size pro rata allocations at $1.06. That is, the incoming Directed Order would execute against the full size of Firm 1's Order for 50 at $1.05. Firms 2 and 3 would each receive an allocation of 100 contracts, and MM1 would receive an allocation of 50 contracts. Thus, MM1 would be incentivized to quote at the NBBO.

<u>Directed Order Process on BX:</u>

NBBO: $1.00 - $1.05 (100 x 50)

Firm 1 Order A Sell at $1.05 for 50
Firm 2 Order B Sell 200 at $1.06
Firm 3 Order C Sell 200 at $1.06
MM1 Quote D: $1.00 - $1.06 (size 100 x 100)

Incoming Buy Directed Order to MM1 for 300.

Under the BX Proposal, MM1 is less concerned about not receiving a full execution when quoting $1.00 - $1.06 and thus has no incentive to quote aggressively. An incoming buy Directed Order to MM1 for 300 would execute first against Firm 1's Order for 50 at $1.05. Next, because MM1 is priced at the now best offer but does not have time priority, MM1 would receive 40 percent of the remaining Directed Order, which would be 100 contracts (40% x 250 = 100). The Directed Order would then execute against Firm 2 for 150 at $1.06.[11] Because of the BX Proposal's design, MM1 would no longer be required to quote at the NBBO to receive its Directed Allocation.

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[9] Under NYSE MKT Rules, MM1 would receive the greater of the guaranteed allocation or a size pro rata allocation, but in either case, no greater than the size of MM1's disseminated size. In the example provided, MM1's allocation under either method would be its full disseminated size, 100 contracts, because both its guaranteed allocation (40 percent of 300) and size pro rata allocation (66 2/3 percent of 300) would each be greater than the disseminated size of MM1's quote.

[10] Like other exchanges, NYSE MKT will route to away markets to trade against any $1.05 offers before trading on NYSE MKT at $1.06.

[11] The Exchange notes that under the BX Proposal, Firm 3 does not receive an execution because of MM1's ability to gain priority even when not quoting at the NBBO. Thus, Firm 3 is disincentivized from providing depth-of-book liquidity.

The Exchange does not believe that the BX Proposal would create additional liquidity in the options markets; rather, it would likely shift liquidity from the top-of-book to depth-of-book. In other words, the BX Proposal is likely to move options liquidity to prices that are inferior for investors (but preferable for market makers quoting at prices inferior to the original NBBO).

BX also states in its response to the NYSE Response Letter that the "'lay in wait' strategy places a market maker at risk of not participating in executions at all, particularly respecting smaller orders," and "[t]he intense competition at the NBBO, both on BX as well as other options exchanges, would limit the effectiveness of this strategy."[12] First, if BX does not believe that this "lay in wait" strategy would be effective, then why does BX believe that the BX Proposal would increase the depth of the market? It would seem that Directed Market Makers only would increase the liquidity at multiple price levels below the top-of-book if they believed that they were going to receive fills at those prices. Either the "lay in wait" strategy" would be effective or market depth would not increase. Second, BX has failed to address why such a strategy would not be particularly effective in thinly-traded series. Where an option is thinly traded, Directed Market Makers will have little or no incentive to match, let alone improve, the NBBO since there is less risk that a Directed Order will be fully executed against better-priced orders.

II. <u>The BX Proposal Places Public Customers at a Disadvantage to Directed Market Makers</u>

In the Order Instituting Proceedings, the Commission questioned whether BX's Proposal "is designed to protect investors in that the proposal would provide Directed Market Makers with priority for Directed Allocations ahead of Public Customer limit orders that arrived first in time."[13] NYSE raised similar concerns in its previous comment letter, noting that the options markets have had a longstanding distinction between a public customer and a professional; marketplace advantages are provided to public customers to level the playing field between retail investors and market professionals. The BX Proposal, however, is attempting to turn this distinction on its head and provide preferential treatment, not to public customers, but instead to sophisticated professionals.

In its response to the NYSE Response Letter, BX states that "[c]ustomer priority is not mandated by the [Securities Exchange Act of 1934] or the rules and regulations thereunder."[14] Although customer priority may not be mandated under price-time priority models, the BX Proposal would permit a Directed Market Maker to jump ahead of equally-priced, earlier-

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[12] BX Letter at 2.
[13] *See* Order Instituting Proceedings at 11.
[14] *See* BX Letter at 3.

arriving customer orders. As a result, the BX Proposal would disadvantage public customers, giving less weight to quoting aggressively at the NBBO than to being a market professional.[15]

BX's contention that that the Proposal would benefit investors because public customers might not execute on BX absent routing of Directed Orders to BX is misleading. Although the BX Proposal could cause a greater number of Directed Orders to be sent to BX because of terms in the BX Proposal favorable to Directed Market Makers, that increased order flow would be siphoned from order flow previously directed to other exchanges where public customers are sufficiently protected and respected. The need to compete for Directed Order flow could lead other exchanges to adopt similar rules regarding Directed Orders. If all exchanges were to treat Directed Orders in the same manner as set out in the BX Proposal, public customers would be disadvantaged. They would lose priority on all exchanges to later-arriving Directed Market Makers and would receive fewer fills, a result inconsistent with the protection of investors.

## III. Conclusion

As previously stated, and reiterated above, NYSE believes the BX Proposal would inhibit the public price discovery process and lessen the incentive to publicly display orders at aggressive prices. More troubling, the BX Proposal would put public customers at a disadvantage to Directed Market Makers by permitting later arriving Directed Market Maker quotes to jump ahead in priority over public customers willing to improve the NBBO. While NYSE welcomes additional competition among exchanges, NYSE does not believe that such competition should come at the expense of the quality of the market or the protection of investors. 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

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[15] *See* Securities Exchange Act Release No. 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 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.").