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April 5, 2010

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: File Nos. SR-Phlx-2010-033 and SR-Phlx-2010-041, Response to Comment of NYSE Euronext, Inc.

Dear Ms. Murphy:

On March 25, 2010, NYSE Euronext, Inc. filed a comment letter asking the Commission to block price competition and protect NYSE Arca's market share.[1] The stated premise of the comment letter is that NASDAQ OMX PHLX pricing does not encourage competitive quoting, however empirical data shows that PHLX quotes became substantially more aggressive after the new pricing model took effect. Set forth below is NASDAQ OMX's point-by-point correction of the most serious of the factual inaccuracies contained in NYSE Arca's letter.

Initially, it is important to put NYSE Arca's letter into perspective. First, option trading in the U.S. is intensely competitive. The eight existing options exchanges compete vigorously; none of the eight currently executes more than 30 percent of equity option trades. In the last six months, one new market has been approved and at least two new entrants have announced plans to launch new options markets this year. The Commission has traditionally been reluctant to block competition by existing markets and, as Erik Sirri recently told the U.S. Chamber of Commerce, the Commission's policy towards new market entry has been to "let a thousand flowers bloom." These Commission policies have increased competition and benefitted investors tremendously.

NYSE Arca is using the regulatory process to thwart that competition. For the last six months, PHLX has been attempting to compete by reducing its prices. As a result of price cuts, PHLX market share has grown. For example, in just three months of price cuts, PHLX market share has grown from 12.1% to 28.2% in the options that are subject to maker/taker pricing. NYSE Arca market share in those options has decreased from 20.7% to 13.4% because of its unwillingness or inability to compete as aggressively as PHLX. Several markets, including NYSE Amex and the International Securities Exchange, have responded to PHLX price cuts by

[1] *See* letter from Janet M. Kissane, Senior Vice President, NYSE Euronext, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission ("SEC" or "Commission") dated March 25, 2010.

changing their pricing effective April 1st.[2] Commission policies are designed to create precisely this form of competition.

Contrary to NYSE Arca's unsubstantiated assertion, PHLX price reductions have helped to improve rather than harm PHLX market quality. Since the inception of maker/taker pricing, PHLX quoted spreads have narrowed substantially, posted size has increased significantly, executed volume has doubled, average execution speed has increased, and PHLX's volume at the inside market has increased for all affected options and for all categories of market participants. These improvements, which benefit investors, are a direct consequence of aggressive quoting behavior encouraged by maker/taker pricing.

Competition law principles suggest that the Commission should proceed cautiously when one exchange seeks to prevent a competing exchange from changing its fees, particularly in a market as competitive as the U.S. options markets. The Commission has a statutory duty to promote competition, including price competition. Congress directed that exchanges' fee changes be deemed immediately effective for the expressed purpose of promoting price competition between markets. The Commission's traditional restraint in regulating fees has fostered intense competition that benefits investors and all market participants greatly.

NYSE Arca's objection to PHLX's differentiated price reductions is unfounded. Segmented pricing is a sign of market health. In mature markets where competition is vibrant, pricing changes are often the most effective way for markets to compete vigorously. Highly differentiated pricing, such as by customer type, is a common and appropriate way that businesses compete. Where participants view pricing on one options market as unpalatable, they are free to move business to another market or markets with favorable pricing. Price competition works best where a variety of different models and pricing schemes exist from which to choose and market participants are highly knowledgeable about alternatives.

The Commission's analysis of differentiated pricing should be more dynamic than NYSE Arca's letter suggests. The Commission is currently explicitly permitting or consciously overlooking some forms of price differentiation that have a great impact on competition, while prohibiting or scrutinizing closely other forms of price differentiation that may have lesser impact. For example, the Commission has accepted volume discounts that apply to very few participants with high trading volumes, while prohibiting differentiation that benefits numerous participants with low volumes.

Additionally, the Commission has permitted market participants to make equity investments in exchanges. These equity investments directly impact competition for order flow in the same way maker/taker pricing impacts competition. The terms of those equity investments are not the subject of public-available proposed rule changes and their impact has not been publicly analyzed or compared to other aspects of price competition, such as volume discounts and maker/taker pricing. PHLX's proposed fees are more transparent, more consistent with the statute, and fairer to investors than equity investments or volume discounts.

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[2] *See, e.g.*, SR-ISE-2010-25 and SR-NYSE Amex-2010-30 (March 31, 2010).

In addition to these flaws, NYSE Arca makes numerous inaccurate statements that require correction.

Inaccuracy #1: ***NYSE Arca alleges that PHLX's pricing does not encourage competitive quoting or posting of orders.***

NYSE's statement is inaccurate. PHLX pricing encourages aggressive quoting by offering liquidity providers a rebate for executions. In order to earn the rebate, liquidity providers must post quotes that are executed. In order to be executed, quotes must be at the inside market at PHLX and they must also be at the national best bid and offer ("NBBO"). Liquidity providers that do not post aggressive quotes will earn no rebate. As is the case at all options markets, PHLX pricing, including the liquidity provider rebate, is tailored to incentivize aggressive quoting by participants with diverse motivations. Some participants are motivated by low execution prices, others are motivated by high liquidity provider rebates and still others are motivated by speed, depth of liquidity, certainty of execution, or a combination of many factors. The fact that the liquidity provider rebate is available to certain market participants and not others does not diminish the overall ability of PHLX to attract quotes and orders to its market.

Improvements in PHLX's market quality and PHLX's success in attracting market share from NYSE Arca and other markets demonstrates that PHLX is attracting aggressive quotations. Since launching the make/take pricing, PHLX market quality in those symbols has improved dramatically in important ways; quoted spreads have declined, quoted size has increased, and execution speed has improved. As a result, PHLX market share in make/take symbols has increased from 12.1% to 28.2% in the three months since it launched maker/taker pricing. These improvements, which benefit investors greatly, are a direct consequence of aggressive quoting behavior encouraged by make/take pricing. If PHLX participants were not quoting aggressively, none of these improvements would occur.

Inaccuracy #2: ***NYSE Arca alleges that in a pro rata model, the participants that are most incentivized to compete for the posting credit are not rewarded for their effort, but rather must compete for the" spoils" remaining after Customers and guaranteed allocation recipients are apportioned their share.***

NYSE Arca asks the Commission to abandon its traditional approach of fostering competition by permitting exchanges to adopt different market structures and business models. The Commission has succeeded in shaping the national market system by promoting competition among orders and among markets. Market structure has evolved and improved over time as exchanges adopt new approaches that eclipse old, outdated ones. The NYSE floor is a perfect example of how an outdated market structure and business model is eclipsed and then evolves. The Commission has never stifled competition by picking one preferred market structure or business model, and it should not do so here to protect a disgruntled competitor.

Additionally, NYSE Arca's statement incorrectly assumes that participants designated as firms and broker-dealers are disproportionately seeking to add liquidity which has not been the case. Firm and broker-dealer orders are important to the PHLX market and the mix of orders it attracts. Based on empirical data and experience, firms and broker-dealers often represent a "taker" approach; generally speaking, they proactively select an options trading strategy and enter orders to take liquidity when the strategy dictates. In contrast, market makers have a stronger incentive to compete for posting credit because their strategy depends on continuous turnover. In that sense, market makers are reactive, providing markets and size, waiting for the arrival of contra-side trading interest. Moreover, the "spoils" are actually valuable marketable liquidity that attracts trading interest from non-customers.

Differentiation amongst market participants is not limited to price. For example, the SEC Quote Rule permits options exchanges to establish rules requiring a different firm quotation size for broker-dealers than for customers.[3] While competition has caused virtually all options exchanges to be firm to all participants for their full disseminated size, many exchanges initially established a lower firm quote size for broker-dealers than for customers. More precedent for disparate (but not unfairly discriminatory) treatment of firms and broker-dealers exists in the Commission's approval of electronic trade allocation algorithms in place on many exchanges, under which firms and broker-dealers on parity with other participants are entitled to receive trade allocations at a price level only after customers and market makers have received theirs.

Inaccuracy #3: ***NYSE Arca alleges that the application of a make/take pricing mechanism within such a [pro rata] structure ... negatively impacts competition and actively discourages market participants from posting or interacting with liquidity.***

In fact, as stated above, the PHLX has observed that investors and the quality of its markets in "maker/taker" symbols has benefitted substantially in a variety of ways. Quoted spreads have narrowed substantially, posted size has increased dramatically, average execution speed has increased and PHLX's volume at the inside market has increased in these options for all categories of market participants. Moreover, the vast majority of market participants benefit from the combination of the Exchange's pricing and market model.

NYSE Arca's criticism of the PHLX pro rata allocation model ignores the importance of liquidity. PHLX maker/taker pricing has attracted liquidity from all market participants; in particular, rebates have attracted more market makers, which PHLX considers beneficial. The large trading interest that PHLX now typically displays in maker/taker options symbols attracts orders from a variety of participants, regardless of whether a rebate is available to them or not. This behavior demonstrates the importance of deep liquidity.

Inaccuracy #4: ***NYSE Arca alleges that the combination of PHLX's pricing and its market structure results in the creation of a private market for customers and market makers at the expense of all other market participants.***

The PHLX is far from being a "private market," but rather represents a blend of quotes and orders from participants with diverse business models. PHLX currently attracts over 30 market

3 17 CFR Section 242.602.

makers, has deeper liquidity than other markets including NYSE Arca, and like every other exchange its quotes are publicly available in the consolidated quote stream. Order flow from "Firms" has increased 158% since the implementation of the make/take pricing and the number of member organizations trading in the make/take symbols on PHLX has also increased. PHLX is in no sense a private market.

Inaccuracy #5: NYSE Arca alleges that Specialists and Directed Participants " jump the line" on priority.

On PHLX, customers have priority over all specialists and directed participants.[4] Directed participants do not jump ahead of nondirected customers. Rather, the pro rata model with a directed order component merely permits a larger percentage of an order to be allocated to the directed participant, *provided* the directed participant is quoting at the NBBO. Additionally, when this occurs, the directed participant's quotation size is considered and the directed participant is not entitled to a number of contracts greater than that participant's quote size. Accordingly, this model (which is similar to the approach of other exchanges) takes competitive quoting and liquidity into account, even while offering a guaranteed allocation.[5]

Inaccuracy #6: Make/take pricing is typically designed to encourage improved pricing on the bid or offer by giving a credit to the participant that posted liquidity.

NYSE Arca's comments distort the Exchange's model, creating the mistaken impression that it is inferior to the price-time model, particularly when combined with make/take pricing. While maker/taker pricing is designed to encourage tight markets, it is important to remember that make/take pricing is also designed to encourage the posting of liquidity and it has done so for PHLX. This is especially apparent in options that trade at the minimum increment, including where multiple exchanges quote at the NBBO.

Inaccuracy #7: NYSE Arca alleges that in the PHLX's market structure competition for order flow is based on size and not for posting an improved price.

Competition based on size is important to execution quality and speed. Due in part to a national market system plan that protects the best price and requires exchanges to avoid trade-throughs, orders are price protected regardless of the exchange on which they were entered. Consequently, members competing for order flow compete on price first and foremost; size competition is secondary. [6] Options exchanges are efficiently linked through sophisticated

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4 PHLX Rule 1014(g)(viii)(A).

5 *See e.g.,* NYSE Arca Rule 6.88 and ISE Rules 713 and 811.

6 Many of the options subject to PHLX's maker/taker pricing trade in penny increments and have penny wide markets. As a practical matter, one cannot quote to improve the NBBO in a penny wide market by tightening the bid/ask spread, such that the liquidity available becomes even more important.

routing mechanisms, making it simpler to obtain the best price. In today's world, being first to improve the NBBO, although important, is not enough. PHLX make/take pricing is designed to encourage and actually results in PHLX not just improving the NBBO, but improving the NBBO with size.[7] Increasing available trading interest on our market is important to the order routing decisions of order entry firms. PHLX also competes to "move up the routing tables" of order entry firms by offering superior technology, reliability, data products, routing services, connectivity and overall service.

Conclusion

NYSE Arca's comment letter misrepresents the operation and effect of the PHLX market and fee schedule, a critical element of competition in an intensely competitive business environment. It is inappropriately using the notice and comment process to delay or derail another competitor's innovation by calling for abrogation. The Commission and its staff should not permit a game to be made of the notice and comment process when comment letters do not raise *bona fide* issues under the statutory standard.

[7] We disagree with NYSE Arca's suggestion that the PHLX's current structure contravenes the September 2000 Order for many reasons; the rule changes that were adopted pursuant to the undertaking cited resulted in important changes to the Exchange's market structure and laid the groundwork for competition-enhancing innovations such as streaming quotes and competing market makers.

As set forth in the PHLX's filings, applying maker/taker pricing to a size pro rata model benefits investors and is consistent with applicable statutory standards of reasonableness and fair discrimination.[8] As competition in options pricing intensifies and options fee schedules become more complex, applying such statutory standards will also be complex. Commission staff should carefully consider the context in which they are applied. Critically, that context includes the competitive nature of the options markets in general, as described above, as well as how a particular pricing proposal may impact the equity owners of an exchange. Fair and reasonable pricing does not mean equal pricing.[9]

In the context of fee filings in a highly competitive market, the Commission should use its authority to abrogate filings judiciously, not arbitrarily.

Sincerely,

J. C. Conley

Joan C. Conley

cc: Mary L. Schapiro, Chairman
Kathleen L. Casey, Commissioner
Elisse B. Walter, Commissioner
Luis A. Aguilar, Commissioner
Troy A. Paredes, Commissioner
Robert Cook, Director, Division of Trading and Markets
Jamie Brigagliano, Deputy Director, Division of Trading and Markets
Elizabeth King, Associate Director, Division of Trading and Markets

[8] Maker/taker pricing has been applied to a market model that is not based on price-time priority, albeit in the context of equities trading; specifically, the New York Stock Exchange has applied a make/take pricing approach to its parity allocation model.

[9] In fact, other maker/taker fee schedules contain different fees and rebates for different market participants.