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

File Nos. SR-Phlx-2012-27 and SR-Phlx-2012-54

Dear Ms. Murphy:

The NASDAQ OMX Group, Inc. ("NASDAQ") is the largest global operator of free markets, including three U.S. options markets. NASDAQ OMX PHLX LLC, a subsidiary of NASDAQ, filed two immediately effective rule proposals, SR-Phlx-2012-27[1] and SR-Phlx-2012-54,[2] to amend certain options fees and rebates on March 1, 2012 and April 23, 2012, respectively. By order dated April 30, 2012, the Commission temporarily suspended these rule filings and instituted proceedings to determine whether the rule changes should be approved or disapproved ("Suspension Order").[3] Specifically, the Suspension Order noted that "[t]he Commission intends to further assess whether the resulting fee disparity between Directed Participants and Market Makers ($0.05 per contract) is consistent with the statutory requirements applicable to a national securities exchange under the Act…" NASDAQ seeks to comment on the Suspension Order to respond to the Commission's questions and express its viewpoint with respect to pricing-related rule changes and the benefits of promoting competition.

INTRODUCTION

NASDAQ seeks to amend its fees to compete on price to attract order flow from directed order flow providers. NASDAQ and other exchanges are engaged in an intense competition on

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1 See Securities Exchange Act Release No. 66551 (March 9, 2012), 77 FR 15400 (March 15, 2012) (SR-Phlx-2012-27) (hereinafter "2012-27 Notice").

2 See Securities Exchange Act Release No. 66883 (April 30, 2012), 77 FR 26591 (May 4, 2012) (SR-Phlx-2012-54) (hereinafter "2012-54 Notice").

3 See Securities Exchange Act Release No. 66884 (April 30, 2012), 77 FR 26595 (May 4, 2012) (Suspension of and Order Instituting Proceedings To Determine Whether To Approve or Disapprove Proposed Rule Changes Relating to Complex Order Fees and Rebates for Adding and Removing Liquidity in Select Symbols).

price (and other dimensions of competition) to attract order flow from these providers. And, critically, the Commission has approved several previous price incentives of this nature that were part of this same competition. These price incentives are the essence of competition — they encourage market participants to provide attractive offerings to consumers, they benefit market participants who trade on the exchange, and, in turn, they benefit consumers who enjoy greater price transparency and execution at lower prices.

The Commission's suspension of NASDAQ's rule arbitrarily stifles one exchange's ability to compete on the merits, where other competing exchanges have been permitted to employ identical competitive tactics in the recent past. Moreover, the Commission's action results in increased prices to innovative market participants and ultimately raises prices on consumers. There is no sound basis to stand in the way of NASDAQ's participation in fair, intense, and open competition.

Incentivizing order flow providers to direct orders is a popular pricing mechanism because customers trading on an exchange can channel orders to particular market makers who provide enhanced price transparency, which can lead to price improvement for customers. These programs attract more liquidity, which in turn benefits all market makers who trade on an exchange that has attracted their volume. Through its fee filing, NASDAQ seeks to amend its Fee Schedule so that Market Makers pay five cents less per contract when executing directed order flow (as a "Directed Participant") than when executing other types of orders (as a "Non-Directed Participant"). This reduced price for directed order flow is one of the competitive tools that exchanges like NASDAQ have at their disposal and use to compete for liquidity.

The options market is characterized by intense competition, and NASDAQ uses a variety of incentives — from rebates to customer service to competitive fees — to entice market participants to trade on the exchange. For example, by offering a reduced execution fee for directed order flow, NASDAQ seeks to encourage Market Makers to attract liquidity, which benefits all market participants. This type of vigorous price competition has multiple benefits: Directed Participants pay less in fees, exchanges benefit from increased order flow, and customers receive enhanced price transparency. In addition, because Directed Participants participate in an intensely competitive environment, it is likely that they pass along savings realized by these fees to their own clients. This is exactly the way a competitive market should work. And these are precisely the benefits from competition that the Commission has sought to achieve.

The fact that Directed Participants and Non-Directed Participants will pay different fees under its rule change provides no sound basis to stifle NASDAQ's effort to compete through this price reduction. First, all Market Makers are treated the same and operate under precisely the same rules, with the exception for quoting described hereafter: If a Market Maker executes directed order flow intended for it, that Market Maker receives a nickel discount, whereas if it takes non-directed order flow, it does not. Second, the difference in fees for directed order flow and non-directed order flow results from two underlying economic realities: (a) Directed Participants must incur additional costs that other Market Makers do not, and (b) Directed

Participants offer a unique service to customers that enhances their value in a competitive marketplace.

Specifically, Directed Participants must pay a fee to an order flow provider ("OFP") for the right to receive directed orders. Directed Participants also have additional quoting obligations that other Market Makers do not. In return, Directed Participants receive a guaranteed allocation of simple (or non-Complex) customer orders. On Complex Orders, however, Directed Participants do not receive any allocation or priority, but must compete on equal footing with Non-Directed Participants for order flow. Thus, while both Directed and Non-Directed Participants benefit from the Complex Orders that customers bring to the exchange, Directed Participants bear a disproportionate share of the costs associated with attracting that order flow.

When exchanges provide financial incentives to market makers to invest in creating and maintaining innovative and desirable products and services, customers reap the benefits. A blind adherence to the notion that all products and all prices must be identical would lead to a stagnant marketplace with uniform product offerings, and customers would ultimately suffer. There is also precedent for such differential pricing between differently situated participants: In 2010, NYSE Alternext US, LLC ("NYSE Alternext," which became NYSE Amex, LLC (hereinafter "Amex")), instituted a $0.02 differential for fees charged to Directed and Non-Directed Participants, which increased to $0.07 for a particular subset of Directed Participants (Specialists and eSpecialists). That rule took immediate effect and was not abrogated by the Commission. Believing that this price difference would attract more order flow to Amex, NASDAQ and other exchanges followed suit to offer the $0.02 incentive. This intense price competition among exchanges is evidence of a vibrant market for options order flow.

Regulation NMS and other statements by the Commission have also made clear that the Commission should rely on competitive forces, to the extent possible, to determine the reasonableness of fees. Here, there is sound reason for differential pricing and every reason to believe that the options market is properly functioning. There is no basis or need for the Commission to prevent exchanges from competing along this dimension or to prohibit them from making their platforms more attractive for Directed Participants, in particular since similar fee filings have taken effect without abrogation. For these reasons, the Commission should approve NASDAQ's rule filings.

ANALYSIS

I. The Commission Has Previously Permitted Exchanges To Charge Different Fees To Directed And Non-Directed Participants; NASDAQ's Current Rule Proposals Are Consistent With These Past Filings.

On March 10, 2010, Amex filed a rule change, which became immediately effective, assessing a $0.02 price differential in the fees that Amex charged to certain types of Directed Participants and Non-Directed Participants.[4]

In its rule filing, among other changes to its fee schedule, Amex adopted the following fees: a transaction fee for a Specialist and eSpecialist of $.10 per contract, a transaction fee for an NYSE Amex Options Market Maker-Non-Directed of $.17 per contract, and a transaction fee for an NYSE Amex Options Market Maker – Directed of $.15 per contract.[55] Amex stated that it "believes that the proposal is consistent with Section 6(b) of the Act, in general, and Section 6(b)(4), in particular, in that it provides for the equitable allocation of dues, fees and other charges among its members and other market participants that use the trading facilities of NYSE Amex Options. Under this proposal, all similarly situated members and other … participants of NYSE Amex Options will be charged the same reasonable dues, fees and other charges."[6] This rule filing instituted a $0.02 price differential between fees charged to certain Directed Participants and Non-Directed Participants, as well as a ***$0.07*** differential between fees charged to a particular category of Directed Participants (Specialists and eSpecialists) and Non-Directed Participants. The rule filing took immediate effect and was not abrogated by the Commission.[7]

In response to this offering, NASDAQ amended its Fee Schedule[8] to replicate Amex's $0.02 fee differential.[9] The Exchange reasoned in that filing that "its proposal is consistent with the current fee schedule and industry fee assessments of member firms that allow for different rates to be charged for different order types originated by dissimilarly classified market

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4 See Securities Exchange Release Act. 59,478 (Feb. 27, 2009), 74 Fed. Reg. 9,857 (March 6, 2009) (SR-NYSEALTR-2009-19).

5 Id.

6 Id.

7 As noted in the Suspension Order, the Commission did summarily abrogate three rule filings made by NASDAQ around the same time that proposed modifications in its Fee Schedule to certain fees and rebates, including a fee differential between Directed and Non-Directed Participants. See Securities and Exchange Act Release No. 61547 (February 19, 2010), 75 Fed. Reg. 8,762 (February 25, 2010) (an Order of Summary Abrogation relating to SR-Phlx-2009-104, SR-Phlx-2009-116 and SR-Phlx-2010-14). The Commission did not indicate what specifically it found worrisome about NASDAQ's fee filings, however, except that it thought the proposals should not be designated immediately effective before opportunity for public comment. 75 Fed. Reg. at 8,763.

8 The Exchange has since amended the title of its "Fee Schedule" to a "Pricing Schedule."

9 See Securities and Exchange Act Release No. 61684 (March 10, 2010), 75 FR 13189 (March 18, 2010) (SR-Phlx-2010-33) (Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to Fees and Rebates for Adding and Removing Liquidity).

participants."[10] Also, it noted that "[o]rder flow providers that control customer order flow and route customer orders to exchanges are responsible to obtain the best pricing available for their customers. An order flow provider has the ability to enter into arrangements whereby they may receive consideration for directing the customer order to a specific market maker (Specialists, ROTs, SQTs and/or RSQTs)."[11] The Commission did not abrogate that fee filing either. Other exchanges since followed suit and instituted a similar $0.02 differential between transaction fees charged to Directed and Non-Directed Participants.[12]

On February 29, 2012, Amex filed a rule change, SR-NYSEAmex-2012-16, to increase per contract execution costs for certain market participants.[13] The Exchange specifically proposed to increase the NYSE Amex Options Market Maker – Directed from $0.15 to $.18 per contract, the NYSE Amex Options Market Maker-non-Directed from $.17 per contract to $.20 per contract and the fee for Specialists and eSpecialists from $.10 to $.13 per contract.[14] The reason for the higher fees was the additional costs incurred by market participants on account of increased order flow to the exchange: "[t]he Exchange believes that the proposed change to increase the fee for NYSE Amex Specialists, eSpecialists, Market Makers who trade with directed and non-directed order flow, Professional Customers and Non-NYSE Amex Options Market Makers transacting on the Exchange is reasonable, given the growth in volumes over the past two years."[15] But in increasing fees, Amex maintained the $0.07 fee differential between Specialists and eSpecialists on one hand and Non-Directed Participants on the other, as well as the $0.02 fee differential between other Directed Participants and Non-Directed Participants.

In its rule filing, Amex noted in the section on burden on competition that it "… does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act." The Amex Specialist, eSpecialist and Market Maker fees noted herein, which were filed ***one business day*** prior to SR-Phlx-2012-27, remain in effect and were not suspended by the Commission. The Exchange made explicit reference to the Amex fee schedule in SR-Phlx-2012-54, stating that its fee

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[10] See Securities Exchange Act Release No. 61684 (March 10, 2010), 75 FR 13189 (March 18, 2010) (SR-Phlx-2010-33).

[11] Id.

[12] See, e.g., International Securities Exchange LLC ("ISE") Fee Schedule.

[13] See Securities Exchange Act Release No. 66561 (March 9, 2012), 77 FR 15429 (March 15, 2012) (SR-NYSEAmex-2012-16). This rule change also included other proposals to increase fees and modify a threshold. This filing became operative on March 1, 2012.

[14] See Securities Exchange Act Release No. 66561 (March 9, 2012), 77 FR 15429 (March 15, 2012) (SR-NYSEAmex-2012-16).

[15] Id. The Exchange noted that "…ADV on the Exchange increased from 1,653,156 contracts in January 2010 to 2,267,022 contracts ADV in January 2012, or an increase of over 37%." Also, "[t]he proposed per contract increases range from a 7.5% increase for Non-NYSE Amex Options Market Makers to a 30% increase for Specialists and eSpecialists." Which Amex asserted why it was reasonable to increase the per contract rate for NYSE Amex Specialists, eSpecialists, Market Makers that trade with directed and non-directed order flow, Professional Customers, and Non-NYSE Amex Options Market Makers."

differentiation was lower than other fee differentiations that exist today, and have for some time, at Amex. The Exchange maintained that Amex differentiates one type of market maker, the Specialist and eSpecialist, from other Amex Market Makers who receive directed orders, in its pricing with a $.07 per contract fee differential. This argument, that Phlx should be able to assess a fee differential which Amex is permitted to assess today, was not identified or discussed in the Commission's Suspension Order. The Exchange seeks to demonstrate herein the similarity between the Amex fees, which are currently effective, and the Phlx fees, with respect to Market Makers.

Phlx sought in SR-Phlx-2012-27 and SR-Phlx-2012-54 to amend its fees to assess Complex Order fees, applicable to Select Symbols[16], at the following rates:

	Directed Participant	**Market Maker (Non-Directed Participant)**
Fee for Removing Liquidity	$0.32	$0.37

Amex sought in SR-NYSEAmex-2012-16 to amend its Simple and Complex Order fees[17], applicable to all symbols, at the following rates:

	Specialist, eSpecialist	**NYSE Amex Options Market Maker – Directed**	**NYSE Amex Options Market Maker – non-Directed**
Transaction Fee	$0.13	$0.18	$0.20

Phlx defined a Market Maker to include a Specialist[18] and ROT, which includes SQTs and RQTS, for purposes of its Fee Schedule.[19] Phlx defined a Directed Participant as a Market Maker (Specialist, SQT or RSQT) transaction resulting from a Customer order that is (1) directed to it by an order flow provider, and (2) executed by it electronically on Phlx XL II. Phlx noted in SR-Phlx-2012-27 and SR-Phlx-2012-54 the fact that Market Makers have no allocation rights with respect to Complex Orders. Thus, Market Makers who are Directed Participants help

[16] The Complex Order fees that are the subject of SR-Phlx-2012-27 and SR-Phlx-2012-54 apply only to electronic orders.

[17] In a prior rule change, Amex noted that its standard per contract fees apply to electronic complex orders. See Securities Exchange Act 65549 (October 13, 2011), 76 FR 64983 (October 19, 2011) (SR-NYSEAmex-2011-77).

[18] Market Makers include Specialists on Phlx. Further, An options Specialist includes a Remote Specialist which is a defined as an options specialist in one or more classes that does not have a physical presence on an Exchange floor and is approved by the Exchange pursuant to Rule 501. See Exchange Rule 1020.

[19] The Exchange defines all categories of market participants, for purposes of pricing, in the Preface to the Pricing Schedule. The Exchange has amended its definitions since filing SR-Phlx-2012-27 and SR-Phlx-2012-54. Today, Phlx's market participants resemble the Amex categories of market participants.

draw significant liquidity to the exchange and bear substantial costs in doing so, but do not receive any corresponding benefit in allocation when executing Complex Orders (as opposed to simple orders).

By way of comparison, Amex does not define its market participants in its fee schedule, but does define a Specialist, eSpecialist and Market Maker in its rules. Amex Rule 920NY defines Market Makers that are designated as Specialists on the Exchange for all purposes under the Securities Exchange Act of 1934 and the Rules and Regulations thereunder.[20] Further, a Market Maker on Amex is either a Remote Market Maker, a Floor Market Maker, a Specialist or an eSpecialist.[21]

Phlx sets forth market making obligations that are applicable to both Specialists and ROTs in Rule 1014(b)(ii)(D).[22] Amex Market Makers, including a Specialist and eSpecialist, are subject to certain obligations, which include quoting obligations in any assigned series.[23] Market Makers do not have quoting obligations with respect to Complex Orders. Phlx Specialists and ROTs (together Market Makers) are not entitled to a guaranteed allocation when transacting Complex Orders.[24] Pursuant to Amex rules, Amex Market Makers, including Specialists and eSpecialists have no allocation rights or quoting obligations in the Amex complex order[25] system and both Specialists and Market Makers at Amex are eligible to receive orders directed to them for execution.[26] Amex Rule 980NY states that Specialists and Market Makers do not receive a

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[20] See Amex Rule 920NY.

[21] See Amex Rule 920NY.

[22] Phlx Rule 1014sets forth Market Maker obligations. See Rule 1014(b)(ii)(D)

[23] See Amex Rules 925NY, 925.1NY(b), 927NY(c), and 927.5NY.

[24] Market Makers receive no allocation guarantee when a Customer Complex Order is directed to them by an OFP and the order is executed. Complex Orders can be distinguished from Single contra-side transactions with respect to allocation guarantees applicable to Directed Specialists, Directed ROTs, Directed SQTs and Directed RSQTs pursuant to Rule 1014(g)(viii). Directed Specialists, Directed ROTs, Directed SQTs and Directed RSQTs are guaranteed a 40% allocation with respect to Single contra-side transactions eligible as a Directed Order.

[25] Amex defines a complex order as any order involving the simultaneous purchase and/or sale of two or more different option series in the same underlying security, for the same account, in a ratio that is equal to or greater than one-to-three (.333) and less than or equal to three-to-one (3.00) and for the purpose of executing a particular investment strategy or an order to buy or sell a stated number of units of an underlying stock or a security convertible into the underlying stock ("convertible security") coupled with the purchase or sale of option contract(s) on the opposite side of the market representing either (A) the same number of units of the underlying stock or convertible security, or (B) the number of units of the underlying stock necessary to create a delta neutral position, but in no case in a ratio greater than 8 option contracts per unit of trading of the underlying stock or convertible security established for that series by the Clearing Corporation. See Amex Rule 900.3NY (e) and (h).

[26] See Amex Rule 964NY entitled "Display, Priority and Order Allocation-Trading Systems." See also Amex Rule 980NY "Electronic Complex Order Trading." Specialists and Market Makers may receive Directed Orders in their appointed classes in accordance with the provisions of this Rule 964.1NY. See Amex Rule 964NY entitled "Display, Priority and Order Allocation-Trading Systems." See also Amex Rule 980NY "Electronic Complex Order Trading." Electronic complex orders at Amex are governed by Amex Rule 980NY.

guaranteed allocation for electronically executed complex orders.[27] With respect to electronic complex orders, Amex Specialists and Market Makers do not have quoting obligations for complex strategies.[28] Therefore, in summary, both Phlx and Amex rules provide that:

- Specialists are Market Makers with certain quoting obligations, except with respect to Complex Orders.
- Specialists and other Market Makers are eligible to receive directed orders.
- Specialists and other Market Makers are not entitled to a guaranteed allocation when transacting Complex Orders.

Phlx does not assess different fees for Specialists as compared to other Market Makers. Amex, however, assesses fees for Specialists and eSpecialists regardless of whether they execute Directed or non-Directed Orders. Thus, Amex today has a fee differential as between a certain type of Directed Market Maker and non-Directed Market Maker of $0.07 per contract. To NASDAQ's knowledge, there is no material difference between the two exchange platforms or the relevant market participants that would make it appropriate for the Commission to abrogate NASDAQ's filing, which seeks approval for a ***$0.05*** differential between certain Directed and Non-Directed Participants, in light of Amex's currently effective ***$0.07*** differential.

Here is a comparison between the fees that NASDAQ filed and those that were and remain in effect at Amex for electronic Complex Order transactions using comparable captions:[29]

Phlx	**Amex**
Market Maker Directed = $0.32 per contract	Market Maker Directed = $0.18 per contract
Specialist Directed = $0.32 per contract	Specialist Directed = $0.13 per contract
Market Maker – non-Directed = $0.37 per contract	Market Maker – non-Directed = $0.20 per contract

[27] See Amex Rule 980NY (c)(i). The allocation of orders or quotes residing in the Consolidated Book that execute against an Electronic Complex Order shall be done pursuant to NYSE Amex Rule 964NY except that the Specialist Pool and Directed Order Market Maker guaranteed participation afforded in Rule 964NY(c)(2)(B) will not apply to executions against a complex order.

[28] See Securities Exchange Act Release Nos. 60297 (July 13, 2009), 74 FR 35223 (July 20, 2009) (notice of filing of proposed rule change), 60554 (August 21, 2009), 74 FR 43737 (August 27, 2009) (SR-NYSEAmex-2009-42) (Order Granting Accelerated Approval of a Proposed Rule Change). The notice of filing noted that neither an Amex Specialist nor an Amex Market Maker quotes prices for complex strategies.

[29] Phlx fees apply only to Select Symbols whereas Amex transaction fees apply to all symbols. The Phlx Select Symbols are comprised of highly liquid securities. See Section I for a complete listing of Phlx's Select Symbols.

Phlx	Amex
Specialist - non-Directed - $0.37 per contract	Specialist - non-Directed - $0.13 per contract

NASDAQ also made the argument in SR-Phlx-2012-54 that:

> "With no additional quoting obligations or other requirements for complex orders, Amex assesses a Specialist and eSpecialist a fee of $.13 per contract while assessing a NYSE Amex Options Market Maker-Non-Directed a fee of $.20 per contract. This fee differentiation is greater than that currently in place on the Exchange. Amex differentiates one type of market maker, the Specialist and eSpecialist, from other Amex Market Makers who receive directed orders, in its pricing with a $.07 per contract fee differential. As mentioned herein, a Market Maker on Phlx includes Specialists and Remote Specialists. For this reason, the Exchange believes that its current fee differentiation is equitable and not unfairly discriminatory because the fees and fee differentiation in place at the Exchange are competitive with and lower than fees and differentials at other options exchanges." [footnotes omitted]

II. In Light Of Prior Rulemakings, It Would Be Arbitrary and Capricious To Disapprove NASDAQ's Rule.

To allow Amex to assess fees which permit a $0.07 fee differentiation as between a market participant that receives directed orders and one that does not, and suspend a similar, albeit lower, fee differential on Phlx on the basis that Phlx's fee filing does not comport with the Act, would be inconsistent and improper.

"An agency must treat similar cases in a similar manner unless it can provide a legitimate reason for failing to do so."[30] If an agency wishes to change direction from previously-announced policies, it must "provide [a] reasoned explanation for its action."[31] As noted above, the Suspension Order did not address Amex's filings or explain why the $0.05 differential proposed by NASDAQ should be disallowed, while previously-filed and currently-effective $0.02 and $0.07 differentials were not. Nor is there a satisfactory explanation for treating the pricing schemes differently. Rather, both exchanges have proposed these pricing schemes in order to entice market makers to pay for direct order flow, which help draw more liquidity to the exchange. These fees are but one of many competitive tools — including an attractive trading platform, liquidity rebates, and customer service — that exchanges employ in their competitive efforts to attract order flow. It should be beyond serious debate that price competition of this nature is beneficial to market participants and consumers. Cf., e.g., *Cargill, Inc. v. Monfort of Col., Inc.*, 479 U.S. 104, 116 (1986) (identifying "price competition" as "vigorous competition" permitted under the antitrust laws).

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[30] *Indep. Petroleum Ass'n of Am. v. Babbitt*, 92 F.3d 1248, 1258 (D.C. Cir. 1996).

[31] *FCC v. Fox Television Stations, Inc.*, 129 S. Ct. 1800, 1811 (2009).

Nor is it somehow a problem that under NASDAQ's fees, Directed Participants pay $0.05 less per options contract than Non-Directed Participants. There is nothing unfair about this proposal: Like participants are treated alike, and different participants are treated differently, with sound justification for the different treatment. All Market Makers are subject to the same pricing rules: If a Market Maker determined to enter into order flow arrangements and then also executes such directed orders, it receives a reduced fee. Otherwise, all Market Makers are assessed the same fee for non-directed order flow. If the Commission disapproves the rule, it would improperly penalize one group of market participants (Directed Participants) at the expense of another (Non-Directed Participants), even though the two groups provide different levels of service to customers and incur different costs. In particular, Directed Participants have enhanced quoting obligations, and must pay a fee to a third-party order flow provider; Non-Directed Participants choose to trade without incurring these additional costs or supplying these added benefits.

Diversity in the products and services offered by market participants enhances competition and benefits consumers. To establish policies that artificially enforce price uniformity would (i) eliminate incentives for innovative market participants to invest in providing desirable products, (ii) foster marketplace stagnation, and (iii) run directly contrary to sound policy. See, e.g., *United States v. Microsoft Corp.*, 147 F.3d 935, 948 (D.C. Cir. 1998) ("Antitrust scholars have long recognized the undesirability of having courts oversee product design, and any dampening of technological innovation would be at cross purposes with antitrust law.").

NASDAQ's price incentive is a fair and appropriate way for the exchange to compete for order flow by enticing Market Makers to trade on NASDAQ and pay for direct orders. The enhanced quoting obligations assumed by Directed Participants provide additional price transparency for customers and help attract more order flow to the exchange. This results in a more attractive trading platform for all exchange participants. Non-Directed Participants pay more in fees, but add less value and incur fewer costs. Customers in turn benefit from the enhanced services provided by Market Makers that pay for directed orders. And Directed Participants benefit from reduced fees, which results in cost savings they can ultimately pass on to their own clients. Since all market participants benefit from this price differentiation, there is no reasonable basis for the Commission to disallow it. Cf., e.g., *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 220 (1993) (noting that the Robinson-Patman Act "condemns price discrimination only to the extent that it threatens to injure competition," and that "Congress did not intend to outlaw price differences that result from or further the forces of competition"). The fee differential is not only sensible and fair, but enhances competition and encourages the development of a robust, innovative, and competitively diverse marketplace.

Intervention by the Commission in these circumstances also would contravene the Commission's stated policy to permit "market forces, rather than regulatory requirements," to determine to the extent possible the fees that exchanges charge for their services.[32] As an

[32] Regulation NMS, 70 Fed. Reg. 37,496, 37,566-37,568 (Jun. 29, 2005).

Advisory Committee appointed by the Commission to review market data issues explained, "the 'public utility' cost-based ratemaking approach is resource-intensive, involves arbitrary judgments on appropriate costs, and creates distortive economic incentives."[33] And in *NetCoalition v. Securities and Exchange Commission*, 615 F.3d 525, 544 (D.C. Cir. 2010), the D.C. Circuit blessed the Commission's practice of relying on "competitive forces," where possible, to assess the reasonableness of proposed rules. The robust competition that exists in the options market is further reason the Commission should not prohibit the fee change in issue here.

III. The Options Market Is Highly Competitive And Thus Market Forces Should Determine Prices Absent Clear Evidence Of Market Failure.

Options markets operate in an intensely competitive environment. The ability to attract order flow is driven largely by price competition. By example, two of NASDAQ OMX's options exchanges, PHLX and NOM, have modified options trading fees monthly or even bi-monthly to attract new order flow, retain existing order flow, and regain order flow lost to competitors' price cuts. In 2011, PHLX and, NOM filed 71 execution fee changes and options exchanges together filed 173 fee changes (excluding market data, connectivity, colocation, and other fees).

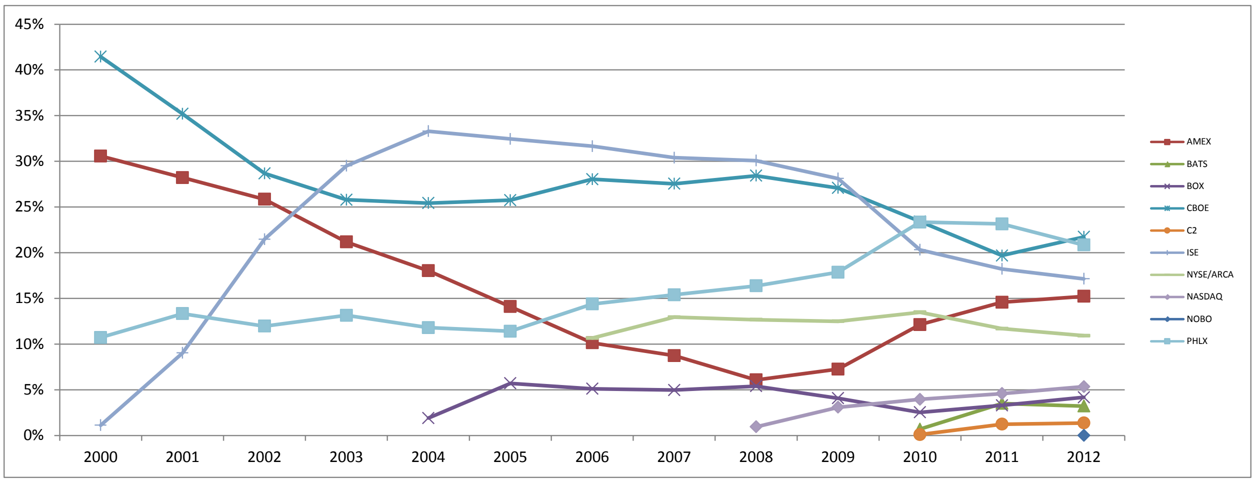
The Suspension Order took issue with the Directed Participant and Market Maker Complex Order Fees for Removing Liquidity in Select Symbols.[34] These very fees, which are part of Phlx's "maker/taker pricing," attract liquidity from all market participants; in particular, rebates have attracted more market makers, which the Exchange considers beneficial. In fact, the large trading interest that the Exchange typically displays in Select 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 and the effectiveness of competition not only among options exchanges, but also among market participants.

The Exchange has found, based on empirical data and experience, 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. This fierce competition has lowered options trading costs, benefitting investors and promoting the goals of the Act. NASDAQ believes the Commission deserves credit for this competition and the resulting price declines; longstanding Commission policies towards trading and market regulation are largely responsible for the strength of current competition.

[33] Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change, at § VII.D.3 (SEC Sept. 14, 2001).

[34] The Select Symbols trade as part of Phlx's "maker/taker" pricing model which has proven to substantially narrow quoted spreads, increase posted size, average execution speed has increased as well as PHLX's volume at the inside market in these options for all categories of market participants. Moreover, the vast majority of market participants continue to benefit from the combination of the Exchange's pricing and market model.

Given this highly competitive environment for options trading and the attendant benefits to investors, NASDAQ suggests the Commission should rely on competitive forces to determine the fair and reasonable price of an exchange's fees. Empirical evidence demonstrates that no exchange has market power sufficient to raise prices for competitively-traded options in an unreasonable or unfairly discriminatory manner in violation of the Exchange Act. In actuality, it is *member firms* that control the order flow that options markets compete to attract.[35] Only by attracting members' orders can options exchanges display bids and offers that are the *sine qua non* of trade executions. This "second-order" competition — where competition is driven by customers rather than sellers of a product — is reflected both in the large number of pricing-related rule changes and also in rapid shifts of market share among multiple effective competitors seen on the chart of equity options market share below.



Further, 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. 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 in which 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.

[35] Michael Porter, *How Competitive Forces Shape Strategy* (Harvard Business Review, 2009).

IV. NASDAQ's Rules Will Enhance The Already Vibrant Competition That Exists In The Options Market.

The Suspension Order provides a brief summary of the rule changes in SR-Phlx-2012-27 and SR-Phlx-2012-54, highlighting only certain aspects of the filings, and notes in the Suspension Order that "[t]he Exchange did not specifically analyze the impact, if any, of the changes to the Complex order taker fees on competition." The Exchange disagrees with this assertion in the Suspension Order. The Exchange did analyze the impact of the changes to competition in both filings as explained in detail below.

The Exchange filed SR-Phlx-2012-27 to amend various fees and rebates in Section I of the Exchange's Fee Schedule, entitled "Rebates and Fees for Adding and Removing Liquidity in Select Symbols." In that filing the Exchange stated that, with respect to the amendments pertaining to the Fees for Removing Liquidity, which are at issue in the Suspension Order, "[t]he proposed changes will enable the Exchange to continue to reward market participants that add liquidity to the Exchange and allow the Exchange to compete more effectively respecting Complex Orders."[36] The Exchange further remarked in the statutory basis that it is reasonable to increase the Complex Order Fees for Removing Liquidity for Market Makers,[37] Directed Participants, [38] Firms, Broker-Dealers and Professionals so that the Exchange can offer increased rebates to Customers.[39] The Exchange stated that Customer rebates attract Customer Complex Orders to the Exchange, benefitting all market participants through increased liquidity.[40] Also, the Exchange indicated that a higher percentage of Customer Complex Orders leads to increased Complex Order auctions and better opportunities for price improvement.[41] Customer Complex Order flow brings unique benefits to the marketplace in terms of liquidity and order interaction.[42] The Exchange increased the Complex Order Fees for Removing Liquidity for all market participants, except Customers, and specified that Market Makers and Directed Participants in particular are assessed lower fees as compared to other market participants because of the quoting obligations applicable to these market participants which do not apply to other market

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[36] See 2012-27 Notice.

[37] A "Market Maker" includes Specialists (See Rule 1020) and Registered Options Traders ("ROTs") (Rule 1014(b)(i) and (ii), which includes Streaming Quote Traders ("SQTs") (See Rule 1014(b)(ii)(A)) and Remote Streaming Quote Traders ("RSQTs") (See Rule 1014(b)(ii)(B)).

[38] The term "Directed Participant" applies to transactions for the account of a Specialist, SQT or RSQT resulting from a Customer order that is (1) directed to it by an order flow provider, and (2) executed by it electronically on Phlx XL II.

[39] See 2012-27 Notice. The Exchange increased certain Complex Order Customer rebates which are not the subject of the Suspension Order. In addition, increases to the Complex Order Fees for Removing Liquidity for a Firm, Professional and Broker-Dealer are not the subject of the Suspension Order.

[40] See 2012-27 Notice.

[41] Id.

[42] Id.

participants.[43] Market Makers who receive directed orders have higher quoting obligations as compared to other Market Makers.[44]

The Exchange asserted that in order to attract Customer Complex Orders in an intensely competitive environment it must continue to adjust its fees and rebates, which benefits all market participants for the good of investors.[45] With respect to competition, the Exchange noted that in order to enjoy the benefits of trading against a directed Complex Customer order by receiving a lower transaction fee (the Directed Participant Complex Order Fee for Removing Liquidity), the transaction must: (i) occur at the best price; and (ii) be directed, by an Order Flow Provider ("OFP"),[46] to the particular Market Maker that executed the order.[47] Further, the Exchange noted that all market participants may compete equally for Customer Complex Order executions, even if that Customer Complex Order is directed to a specific Market Maker.[48] All Market Makers have the ability to incentivize an OFP to direct or preference an order if they desire to enter into, for example, a payment for order flow arrangement with an OFP.[49] The Exchange maintained, with respect to competition, that while all market participants enjoy the benefits of the liquidity that such order flow brings to the market, not all market participants incur the additional expense of paying an OFP for such order flow.[50] (Although NASDAQ does not compile data on the exact prices that Market Makers pay third-party order flow providers for directed order flow, we know that these payment arrangements exist from conversations with online retail brokerage firms and member Market Makers. In many cases, the rates paid by these Market Makers exceed NASDAQ's own exchange-sponsored payment for order flow fee and also exceed the rebates that NASDAQ provides for adding or removing liquidity from the exchange.)[51]

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[43] See 2012-27 Notice. As further noted in SR-Phlx-2012-54, the continuous quoting obligations Market Makers have for each series in which they are do not apply to Customers, Firms, Professionals and Broker-Dealers. Market Makers that receive Directed Orders have higher quoting obligations compared to other Market Makers. See also 2012-54 Notice.

[44] See 2012-27 Notice.

[45] Id.

[46] The term "Order Flow Provider" ("OFP") means any member or member organization that submits, as agent, orders to the Exchange. See Rule 1080(l)(i)(B).

[47] Id.

[48] Id.

[49] Id.

[50] Id.

[51] See Securities Exchange Act Release No. 64781 (June 30, 2011), 76 FR 39953 (July 7, 2011) (SR-BATS-2011-009) (An approval order to establish a directed order program on its options facility ("BATS Options") on a six-month pilot basis). In response to comment letters, thirteen of which were received for this filing, BATS noted market makers already retain the discretion to pay certain firms non-transparent payment for order flow amounts. Further, BATS Options market makers must enter orders that assume the risk of trading with all participants at NBBO, and must commit to price improvement over the NBBO without knowing the details of the particular order and being guaranteed an allocation. BATS argued that by not providing allocation guarantees, the proposed Directed Order program provided incentives to BATS Options market makers as well as Options Members to aggressively quote, both at the NBBO and at non-displayed prices better than the NBBO. See Letter to Elizabeth M. Murphy, Secretary, Commission, from Jeromee Johnson, BATS, dated June

The Exchange provided statistics to display the impact of directed Complex Orders to the market, including a percentage of orders that trade with the intended Market Maker, price improvement, average daily equity options transactions as reported by the Options Price Reporting Authority ("OPRA") and market share numbers for options exchanges.[52] The Exchange asserted that the competition that arises from Market Makers competing for Customer Complex Orders provides the Exchange with greater execution quality which benefits all participants.[53]

The Exchange, in furtherance of its position with respect to its Complex Order Market Maker and Directed Participant Fees for Removing Liquidity in Select Symbols, filed SR-Phlx-2012-54 to provide additional evidence in support of the fees which were in effect since March 1, 2012. In that filing the Exchange further described how the amendments to the Market Maker and Directed Participant Complex Order Fees for Removing Liquidity impact competition, most notably in describing fees in existence at Amex.[54] The Exchange noted that Amex currently has a higher fee differential as compared to Phlx.[55] The Exchange also updated statistics in SR-Phlx-2012-27, accounting for data available since the fees became effective. The data served to display the impact on competition. The Exchange stated in the Statement on Burden on Competition, that "[t] he Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Securities Exchange Act of 1934 ("Act"). Further, the Exchange notes that the Directed Participant and Market Maker Fees for Removing Liquidity currently in place at the Exchange apply only to certain Select Symbols which are Multiply-Listed and highly liquid securities. As described herein, the Exchange's fees are comparable to and lower than other fee differentials today at other options exchanges. Given the highly competitive environment for options trading

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2, 2011. In its approval order, the Commission noted that "[o]n the options markets, specialists and market makers often compete for order flow by offering cash or non-cash inducements, known as payment for order flow ("PFOF"), to brokers to send their orders to a particular market maker or exchange. Under a typical payment for order flow arrangement, a specialist or market maker offers an order entry firm cash or other economic inducement to route its customer orders to that specialist's or market maker's exchange because the specialist or market maker knows it will be able to trade with a portion of all incoming orders, including those from firms with which it has payment for order flow arrangements. Also, PFOF arrangements are prevalent in today's market. These arrangements likely impact the incentives for market makers (or others) to quote aggressively to trade with order flow covered by such PFOF arrangements because market participants know that the market makers will be able to trade with some or all of the captured order flow as long as they match the NBBO (whether by displaying quotes that match the NBBO set by others or by matching better quotes elsewhere pursuant to mechanisms that provide market makers with the opportunity to step-up and trade with orders that are exposed for one second)." The Commission cited another release for a further discussion of PFOF and its impact on the options markets, see also Securities Exchange Act Release No. 49175 (February 3, 2004), 69 FR 6124 (February 9, 2004). BATS did not implement this program for which it received approval.

[52] Id.

[53] Id.

[54] See also 2012-54. Notice. The Exchange described those fees at Amex, which are currently in effect today, in this comment letter.

[55] The Suspension Order does not address the Amex comparison which was detailed in SR-Phlx-2012-54.

and the attendant benefits to investors, the Exchange believes that no exchange has market power sufficient to raise prices for competitively-traded options in an unreasonable or unfairly discriminatory manner in violation of the Exchange Act. In actuality, it is member firms that control the order flow that options markets compete to attract as evidenced by the large number of pricing-related rule changes and shifts of market share among options markets."[56]

Contrary to the assertion in the Suspension Order that the Exchange did not specifically analyze the impact, if any, of the changes to the Complex Order taker fees on competition, the Exchange did in fact analyze competition in multiple forms within the two filings. Also, the Exchange provided updated information containing the time period after the pricing at issue took effect. Competition, as noted time and again by NASDAQ in various comment letters concerning options pricing, is at the very core of such pricing. The Exchange described in its two filings the purpose of fees, the varying obligations among market participants, its goals of increased liquidity, price improvement, and statistics relating to options markets in general and the Phlx market in particular. The Exchange directly addressed competition in Section 4 of SR-Phlx-2012-54 specifically addressing burdens on competition. The rationale and basis provided in this filing directly addressed the very reasons, of which there were several, why Market Makers and in particular Market Makers that receive direct orders have different obligations and that trading benefits the market. The statement in the Suspension Order concerning competition overlooks this evidence.

V. The Exchange Has Identified Substantial Evidence That Shows That Its Proposed Fees Are Reasonable And Not Unfairly Discriminatory.

The Exchange reasoned in SR-Phlx-2012-27 that a fee differential of $0.05 per contract as between Market Makers and Directed Participants is reasonable, equitable and not unfairly discriminatory for various reasons.[57] Prior to these filings at issue a fee differential of $0.02 per contract existed as between Market Makers and Directed Participants in both the Simple market and the Complex market.[58] This fee differential existed on other exchanges along with Phlx, which fee differential was justified by the Market Maker's obligations to the market, which do not apply to other participants.[59] A Market Maker has an obligation to continuously quote in a series to which it is assigned.[60] In addition, a Market Maker executing an order directed to it by

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[56] See also 2012-54. The Exchange notes that in a review of fee filing filed by NYSE Arca, Inc., Amex, the Chicago Board Options Exchange Incorporated, the International Securities Exchange LLC and BATs in 2012 no other exchanges provided analysis on competition in Section 4 of the 19b(4) forms filed with the Commission. The filing, which is the subject of the Suspension Order, is the only fee filing that was suspended in 2012 by the Commission.

[57] See 2012-27 Notice.

[58] A fee differential of $0.02 per contract exists today as between Market Makers and Directed Participants in both the Simple and Complex Order Fees for Removing Liquidity in Select Symbols. See Section I of the Exchange's Pricing Schedule.

[59] See 2012-27 Notice. See also 2012-54 Notice.

[60] Id.

an OFP has higher quoting obligations as compared to other Market Makers.[61] Also, historically higher fees were assessed to its non-Customer market participants in order to offer higher Customer rebates to attract liquidity to the Exchange. The fees at issue provided the revenue to offer the higher Customer rebates which benefitted all market participants from increased Customer liquidity.[62]

Further, Market Makers that execute against a directed Complex Order do not receive a guaranteed allocation as is the case in the Simple market.[63] In the Simple market, the Market Maker executing a directed order is entitled to a reduced fee ($0.02 lower than other Market Makers) and a 40% guaranteed allocation.[64] This is not the case in the Complex Order market, and that distinction justifies a higher differential, as Directed Participants do not receive the same benefit in the Complex Order market for the costs they incur.[65] In addition to that, Market Makers that receive directed orders pay for those orders.[66] Market Makers enter into order flow arrangement at some cost, but may not receive the benefit of the directed order in the form of the lower fee because they were not at the best price to execute that order.[67] At the time of the trade, the Market Maker is unaware of the identity of the contra-party to the trade and must be at the best price to execute the order.[68] This does not occur most of the time, but rather a directed customer Complex Order traded with the Market Maker to which the order was directed less than 18% of the time from September 2011 through mid-April 2012.

The additional expense incurred by a Market Maker to attract the order flow should be considered in assessing fees to Market Makers because they benefit all market participants.[69] The effective rate that is paid by a Market Maker that is the intended recipient of a Customer Complex Order that is only executing a small percentage of the time is less than the $0.05 fee differential.[70] Further, the significant difference in magnitude between the proposed $0.03 per

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[61] Id.

[62] Id.

[63] Id.

[64] Id.

[65] Id.

[66] Id.

[67] Id.

[68] Id. The Exchange indicated that when a Market Maker executes against a Customer Complex Order the Market Maker may do so by responding to an auction, executing against an order on the Complex Order Book ("CBOOK"), or sweeping a resting Customer Complex Order. The Customer Complex Order may also be executed against existing quote and or limit orders on the limit order book for the individual components of the Complex Order. In each of these cases, the order will trade based on the best price or prices available pursuant to Exchange Rules.

[69] Id.

[70] Id. For example if a Market Maker, that is the intended recipient of a Customer Complex Order, only executes the Customer Complex Order 14.5% of the time (paying the Directed Participant Complex Order fee of $0.32 per contract), then that Market Maker is paying the proposed Market Maker Complex Order fee of $0.37 per contract the other 85.5% of the time. The effective Complex Order Fee for Removing Liquidity for that Market

contract increased fee differential and the extent of price improvement supports the reasonableness of the fees because they had a negligible impact on Directed and non-Directed Market Makers.[71] In fact, offering Market Makers that receive directed orders a lower fee encourages Market Makers to enter into order flow arrangements and continue to bring liquidity to the market.[72] Options exchanges aggressively compete for Complex Order flow, which benefits exchanges by incentivizing Market Makers to pay for order flow, thus attracting more liquidity to the Exchange. This benefit is a significant one and should not go unrewarded.

In summary, in the context of fee filings in a highly competitive market, the Commission should not suspend rule filings unless there is concrete evidence that competitive forces are insufficient to constrain price. No such evidence exists here. Therefore, NASDAQ respectfully requests that the Commission approve the rule filings at issue here.

Respectfully submitted,

Joan C. Conley

Joan C. Conley
Senior Vice President &
Corporate Secretary

Maker is $0.3613 in a given month, less than $0.01 below the rate paid by a Market Maker that never receives a Customer Complex Order directed to it for execution. Approximately 80% of Market Makers executing Customer Complex Orders receive an order directed to it for execution.

71 See 2012-27 Notice. See also 2012-54 Notice. The Exchange provided statistics within SR-Phlx-2012-27 based on an analysis of the week of October 10, 2011 indicating that Customer Complex Orders received price improvement 29% of the time and the average level of price improvement was $0.059 per option or $5.90 per contract for options receiving price improvement. The Exchange updated those statistics within SR-Phlx-2012-54 to indicate that based on an analysis of the week of April 9, 2012, Customer Complex Orders received price improvement 29% of the time and the average level of price improvement was $0.056 per option or $5.60 per contract for options receiving price improvement.

72 See 2012-27 Notice. See also 2012-54 Notice.