February 24, 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

**RE: SR-BATS-2010-034**

Ms. Murphy:

BATS Exchange, Inc. ("BATS") is responding to comment letters submitted in response to the above-referenced rule filing ("the Proposal") to establish a directed order program on BATS' options market ("BATS Options"). The Proposal would create two new order types, a Market Maker Price Improving Order and a Directed Order, and it would modify the existing Price Improving Order on BATS Options. In particular under the Proposal, a market maker would have the ability to enter a Market Maker Price Improving Order, which is an order from a market maker that contains both a displayed price and a nondisplayed price better than the national best bid or offer ("NBBO") at which the market maker is willing to trade with an order directed to it. The nondisplayed price of a Market Maker Price Improving Order could be entered in an increment as small as (1) cent, or could be designated as the midpoint of the NBBO.

A Directed Order is an order from any BATS Options member that is directed for execution to a particular BATS Options market maker. To be eligible for execution with a particular market maker, among other things, the Proposal would require that the member sending the Directed Order be on a list of firms provided to BATS Options from whom the particular market maker has indicated it will accept Directed Orders. And, the Proposal would require that the market maker to whom the Directed Order is directed is quoting a Market Maker Price Improving Order with a displayed price equal to the NBB or NBO at the time the Directed Order is entered onto BATS Options. Further, the Proposal would modify BATS Options' existing Price Improving Order by providing any member the ability to submit orders with a nondisplayed amount of price improvement that can be ranked and executed at the midpoint of the NBBO. Finally, in all cases the Proposal would require Market Maker Price Improving Orders to cede priority to any other interest on the BATS Options Book, displayed or nondisplayed, at the same or better price as the nondisplayed price of the Market Maker Price Improving Order, regardless of time priority.

The purpose of the Proposal is to create a directed order program that enhances opportunities available in the market for members to obtain price improvement for customer orders in the context of BATS Options' price/time priority, continuous auction market. As noted in the Proposal:

> "[b]y requiring BATS Options Market Makers to be quoting at the NBB or NBO to participate in an execution against a Directed Order directed to it, BATS' proposal incentivizes market makers to competitively quote and thereby furthers the public price discovery process. By further requiring BATS Options Market Makers to include a non-displayed price better than the displayed limit price at an increment as small as (1) one cent or the midpoint of the NBBO, the proposal increases the opportunities for customer orders to receive price improvement over the NBBO. Moreover, by permitting all Options Members to enter orders in the same increments as Market Maker Price Improving Orders, including as proposed at the midpoint of the NBBO, and according those orders in all cases priority at their non-displayed prices over Market Maker Price Improving Orders, the proposal avoids creating participation guarantees in place at other markets and instead promotes market-wide competition for executions at prices between the NBBO."

Some commenters have questioned certain aspects of the Proposal, primarily the introduction of a midpoint order-type that could result in execution prices at half-penny prices.[1] In addition, some commenters questioned whether the proposal actually incents or impedes the public price discovery process,[2] whether the Proposal would create a two-tiered market,[3] and whether the Proposal would provide too much of a benefit to market makers in the form of interacting with directed order flow without a concomitant obligation on market makers to provide liquidity generally to the market.[4]

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1 See Letter from Angelo Evangelou, Assistant General Counsel, Chicago Board Options Exchange, Incorporated, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated December 28, 2010 ("CBOE Letter"); letter from Tom Wittman, NASDAQ OMX PHLX, Inc. and The NASDAQ Options Market, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated December 28, 2010 ("NASDAQ Letter"); letter from John C. Nagel, Managing Director and General Counsel, Asset Management and Markets, Citadel LLC, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated December 28, 2010 ("Citadel Letter"); letter from Christopher Nagy, Managing Director, Order Strategy, TD Ameritrade, Inc., to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated December 23, 2010; letter from Andrew Stevens, Legal Counsel, IMC Chicago, LLC d/b/a IMC Financial Markets to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated February 7, 2011 ("IMC Letter").

2 See Letter from Anthony J. Saliba, Chief Executive Officer, LiquidPoint, LLC, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated January 3, 2011 ("LiquidPoint Letter"); letter from Janet L. McGinness, SVP and Corporate Secretary, Legal & Government Affairs, NYSE Euronext, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated December 28, 2010 ("NYSE Letter"); letter from Matthew D. Abraham, Chief Compliance Officer, CTC Trading Group, L.L.C., to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated February 4, 2011 ("CTC Letter"); IMC Letter; CBOE Letter; ISE Letter.

3 See LiquidPoint Letter; NASDAQ Letter; ISE Letter.

4 See NASDAQ Letter; ISE Letter.

At the outset, BATS recognizes and appreciates many of the concerns raised by commenters regarding the Proposal's introduction of midpoint orders to the options market. As noted by several commenters, quoting options in penny increments is a relatively new development in the options market and the Commission continues to study its impact. While the Proposal would not as some have implied result in half-penny quotes or the ranking of orders in increments finer than a half-penny, BATS recognizes that further study and consideration may be appropriate before introducing nondisplayed midpoint orders that could execute at a half-penny increment. Consequently, BATS intends to withdraw its current Proposal and submit for public comment a new proposal that removes those aspects that would create midpoint order functionality. In addition, BATS will submit its new proposal as a request to operate its directed order program on a pilot basis, with a commitment to provide information to the Commission related to price improvement and other data deemed necessary to evaluate the effect of the directed order program on BATS Options. Finally, as described below, BATS' new proposal will make clear that only the full *displayed size* of a Market Maker Price Improving Order, is available to trade with a Directed Order at the Price Improving price. BATS addresses the remaining comments below.

Some commenters suggest that the Proposal does not contribute to the public price discovery process, but instead impedes transparency. The basis for these comments is the Proposal's creation of a nondisplayed amount of price improvement for Market Maker Price Improving Orders that can execute only against a Directed Order. BATS strongly disagrees with these commenters, noting that in *all* cases a Market Maker Price Improving Order must include a displayed price that is equal to the NBB or NBO for such order to be eligible to execute at its nondisplayed price against a Directed Order. As such, the Proposal enhances the public price discovery process – if the market maker is not publicly quoting at the NBB or NBO at the time the Directed Order arrives to BATS Options, the market maker will only trade with that Directed Order to the extent that any other interest on the BATS Options Book at or better than the NBB or NBO and any other interest with price/time priority over the market maker's order is first satisfied. Accordingly, in order to enjoy the benefits of trading against Directed Orders, a market maker is required to publicly display a competitively priced order which is available, and hence at risk, to all members.

On a related note, two commenters suggested that a Market Maker Price Improving Order could be entered with a displayed size as small as one contract in order to nominally satisfy this requirement while maintaining a nondisplayed greater size that is available to trade only with Directed Orders.[5] BATS wishes to make clear that this suggestion is incorrect. As currently Proposed, the full displayed size of a Market Maker Price Improving Order, and only the full *displayed size* of a Market Maker Price Improving Order, is available to trade with a Directed Order at the Price Improving price. Key to the structure of the Proposal is that it creates

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[5] See NYSE Letter; IMC Letter.

incentives for *displayed* price and size discovery available to all market participants and, as noted above, BATS will make the question of reserve use abundantly clear in its new filing.

With respect to some commenters' concern that the Proposal creates a two-tiered marketplace or is otherwise unbalanced and non-competitive, such commenters contend both that the Proposal unfairly provides market makers with the ability to determine from whom they are willing to accept Directed Orders and, consequently, to whom they are willing to provide price improvement, as well as that the Proposal does not actually provide a realistic ability for non-market makers to compete for Directed Orders. BATS notes that the Proposal does indeed allow market makers to determine at their discretion the members from whom they will accept Directed Orders. BATS is not proposing to be involved in that determination but rather is proposing only to administer the lists provided to it by market makers. In this regard, BATS notes market makers already retain the discretion to pay certain firms non-transparent payment for order flow ("PFOF") amounts. The Proposal similarly retains that existing discretion for market makers, but provides a mechanism for such payments, or at least a portion of such payments, to be provided in a transparent fashion to the Directed Order in the form of price improvement over the NBBO.

Further, the Proposal provides all market participants, including other market makers that do not have orders directed to them, with the ability to compete with market makers for executions against Directed Orders. BATS notes that one commenter suggested that other market makers will not be able to compete for executions against Directed Orders directed to a particular market maker.[6] BATS asserts that this suggestion is inaccurate because all members, including market makers, have the ability to enter Price Improving Orders and any other orders that can compete in the same price increments with a particular market maker's Market Maker Price Improving Order. In options classes not subject to the penny pilot, market makers and non-market makers have the ability under the Proposal to post orders with nondisplayed prices at penny increments between the NBBO. Importantly, in all cases, market makers cede priority to all other orders priced equal to or greater than the nondisplayed price of their Market Maker Price Improving Orders. In options classes subject to the penny pilot, with the previously mentioned planned amendment to the Proposal removing the midpoint functionality, all market participants can effectively compete against nondisplayed Market Maker Price Improving Orders simply by tightening the NBBO. In BATS' price/time priority market, the nondisplayed portion of a Market Maker Price Improving Order will only execute at the non-displayed price when that price is the best available price.

One commenter also suggested that the Proposal lacks any safeguards currently required by the Commission with respect to existing price improvement auctions in place at other options exchanges.[7] In particular, this commenter noted that the Commission has scrutinized such price improvement auctions and has required those options exchanges offering them to report detailed

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6 See ISE Letter.

7 Id.

information back to the Commission regarding the level of competition occurring during those auctions' separate one-second price improvement period. BATS notes that its Proposal differs significantly from the existing price improvement auctions in place at other options exchanges because the price improvement opportunity occurs in the context of BATS' continuous, price/time priority auction rather than a separate one-second price improvement auction. As such, concerns about customer orders potentially "missing the market" during that exposure period are not present. That said, however, BATS intends to withdraw the current Proposal and submit a new proposal that will explicitly commit to report to the Commission price improvement data and other data deemed necessary to evaluate the impact of the directed order program during a pilot program period.

One commenter questioned whether the nondisplayed portion of a Price Improvement Order will trade if the displayed portion of such order is not at the NBBO at the time of order receipt.[8] As noted at the outset, BATS intends to withdraw the current Proposal and submit a new proposal that removes those aspects that would create midpoint order functionality. As such, under this new proposal, Price Improving Orders will continue to operate as they do today, always displaying at their minimum quote increment, with their non-displayed price available for execution regardless of whether the displayed price is at the NBBO. In contrast, the non-displayed price of a Market Maker Price Improving Order is only available for execution if at the time of receipt of a Directed Order the displayed price of the Market Maker Price Improving Order is equal to the NBBO.

From a broader competitive standpoint, many of the commenters make reference to "internalization".[9] They contend that when BATS' Proposal goes into effect, the markets will simply widen out; that market makers receiving directed orders will simply internalize them, without competition, to a greater extent than occurs today on other options exchanges. BATS rejects these contentions. Today, internalization occurs in the options markets in two ways. First, internalization can occur when an order is facilitated by a member. When facilitating an order, the member has prior knowledge of the customer order and seeks to execute that order on an options market where the member can execute against as much of that customer order as possible. Second, internalization occurs pursuant to directed order programs on some options exchanges where the market maker to whom a customer order is directed is guaranteed a certain percentage allocation of the customer order (typically 40%).

With respect to facilitation, BATS wishes to make clear that its Proposal has no impact on its existing rules regarding customer order facilitation. Today, BATS members seeking to facilitate customer order on BATS Options must comply with facilitation rules requiring the member to expose either the customer order or the principal order on the exchange for one second prior to a facilitation execution. These rules are similar to rules in effect on other

8 See CBOE Letter.

9 See, e.g., NYSE Letter; ISE Letter; CTC Letter.

exchanges, and BATS' Proposal does not amend these requirements.[10] Again, there is no aspect of the Proposal that would lessen the existing exposure requirements.

With respect to broader competitive concerns raised around internalization in the context of the differences between BATS' proposed directed order program and those currently in effect on other options exchanges, BATS believes those concerns are unfounded. In fact, BATS contends that its Proposal will create much greater price competition for customer orders than exists today on other options exchanges. BATS believes that the relationships and incentives currently in place across the options exchanges with directed order programs involve relatively high PFOF rates. With respect to those directed order programs, market makers are not required to be at risk to participate with a directed order and are not required to commit to price improvement before – or even after – receiving a directed order. A market maker can, today, under competing structures, be quoting away from the NBBO and is only required to match competitive prices, to be *guaranteed* a percentage of an incoming customer order.

In contrast, under BATS' Proposal, if the market maker is not quoting displayed size at the NBBO when a Directed Order is sent; if the market maker is not contributing to displayed price and size discovery for the entire market; and if, therefore, the market maker is not putting itself at more risk than what is required under traditional directed order structures, the market maker is "internalizing" absolutely nothing on BATS Options because it will not participate in the execution. In fact, with BATS' recent pricing changes[11] – specifically incenting NBBO setting activity – if market makers were to attempt to widen out the NBBO to internalize customer orders at worse prices, BATS has significantly incented competing members to tighten the spread and compete for these orders. Further, by requiring a commitment of material price improvement at the time of the market maker's order entry, BATS believes the economics of the payment relationships that exist under current directed order programs will shift – away from a pure payment relationship between brokers off the exchange, to payment via price improvement on the exchange, which inures directly to the benefit of the customer order. BATS believes that this result reflects a healthy and competitive development that will enable market participants not part of those relationships today to better compete – on price – for valuable order flow.

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[10] Specifically, BATS Rule 22.12 prohibits members of BATS Options ("Options Members") from executing "as principal orders they represent as agent unless (a) agency orders are first exposed on BATS Options for at least one (1) second or (b) the Options Member has been bidding or offering on BATS Options for at least one (1) second prior to receiving an agency order that is executable against such bid or offer (exposure)." Rule 22.12 prevents Options Members from executing agency orders to increase economic gain from trading against the order without first giving other trading interest on BATS Options an opportunity to either trade with the agency order or to trade at the execution price when the Options Member was already bidding or offering on the book.

[11] See Securities Exchange Act Release No. 63632 (January 3, 2011), 76 FR 1205 (January 7, 2011) (SR-BATS-2010-038) (notice of filing and immediate effectiveness of proposed changes to fees for use of BATS Options, including adoption of the NBBO Setter Rebate for orders that add liquidity and set either the NBB or NBO).

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BATS appreciates the opportunity to provide this response to the comments received on BATS Options proposal to establish a directed order program. Please feel free to contact me if you have any questions in connection with this matter.

Sincerely,

Eric J. Swanson
Secretary