NASDAQ OMX[SM]
PHLX

December 28, 2010

Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street NW
Washington, DC 20549

Re: File No. SR-BATS-2010-034
Sub-Penny Directed Order Program

Dear Ms. Murphy:

NASDAQ OMX PHLX, Inc. ("PHLX") and The NASDAQ Options Market (taken together, "NASDAQ") generally refrain from criticizing proposed rule changes of competing exchanges. Competition and innovation benefit investors because in the long term they improve market structure, increase efficiency, and lower trading costs. The BATS Exchange Proposal to implement a Directed Order Program is no exception, although certain novel features in the proposal raise questions. NASDAQ's comment is aimed at understanding BATS' program with sufficient clarity that NASDAQ can, if it chooses, emulate those novel features confident that they comply with the Exchange Act of 1934.

The first novel feature of the BATS Exchange Proposal is the ability to execute certain price improving orders in sub-penny increments. Generally, NASDAQ favors an intelligent tick regime that accounts for differences in trading based upon the characteristics of different instruments.[1] The options industry, with careful guidance from the Commission, has achieved some degree of differentiation in having options classes quoting in penny, nickel and dime increments. The most notable example is the Commission's "Options Penny Pilot" which was established in January of 2007.

Given the deliberation with which the Commission and staff have approached the Options Penny Pilot, and the fact that it remains a pilot, the question becomes whether the Commission intends to embark upon another pilot, a sub-penny "trading and dark quoting" pilot, in the context of the BATS Exchange proposal. If so, NASDAQ would anticipate that the Commission would first find that the Options Penny Pilot was successful before creating a new sub-penny trading pilot. Additionally, NASDAQ asks that any order approving the BATS Exchange Proposal elaborate upon the conditions for

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1 *See* letter from Joan Conley, Senior Vice President and Corporate Secretary, The NASDAQ OMX Group, Inc., dated April 28, 2010, regarding SEC Concept Release on Market Structure, available at http://sec.gov/comments/s7-02-10/s70210-168.pdf.

engaging in sub-penny trading in options, including the manner in which options classes will be selected for the pilot and the reports that will be required. Finally, NASDAQ urges the Commission to articulate clearly the increment it anticipates can be uniformly applied, *i.e.,* half pennies, tenths, or hundredths. Market participants that trade equities do not have uniform views in that area and some believe this has led to questionable trading practices.

Second, the BATS Exchange Proposal introduces a form of preferential treatment which appears novel: the ability for market makers to provide price improvement to select market participants. Does the Commission intend that registered market makers on all markets should have the ability to selectively offer price improvement? If so, is that ability to offer selective price improvement limited to registered market makers or will it be extended to other participants that might seek it? On what basis would that distinction be drawn? The BATS Exchange Proposal appears to leave individual market makers free to determine the criteria for selecting participants to whom they will offer price improvement. Alternatively, it could be that the BATS Exchange will determine the selection criteria and announce them in some fashion, publicly or privately, to BATS' registered market makers. This is unclear in the filing.

The filing is also unclear about what the selection criteria will be and which criteria are permitted and which forbidden. For example, would a market maker be permitted to offer price improvement based on payment for order flow, based on an affiliate relationship, based on exclusivity arrangements, or based on volume levels? Further, are market makers required to apply those criteria uniformly and are there certain criteria that all market makers must apply to all participants? NASDAQ fully expects that its and other exchange's market makers will ask these and related questions were NASDAQ to adopt a proposal akin to BATS' Directed Order Program.

Third, the BATS Exchange Proposal appears to introduce a level of differentiation that differs from previously-approved Directed and Price Improvement programs at other options exchanges. On NASDAQ OMX PHLX, for example, market makers accepting Directed Orders must hold themselves out via substantially high quoting requirements for all market participants, not just a select few. In addition, PHLX participants that wish to offer price improvement to particular orders must expose those orders to the 'lit' market and compete through an auction process, such as Price Improvement on XL (PIXL).

Lastly, PHLX requests clarification of the following sentence on page six of the BATS Exchange proposed rule change:

> 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.

Is it true that all BATS Options Members will be permitted to enter orders in the same increments as Market Maker Price Improving Orders? The BATS Exchange Proposal could be read to limit that right to Market Makers willing to accept Directed Orders. Also, it may not be accurate to say that all options participants are treated equally. Assuming that all BATS Options Members may enter Price Improving Orders in equivalent increments, orders in penny symbols will always be exposed and at risk, whereas Market Maker Price Improving Orders in penny symbols, on the other hand, will be less at risk. Market Maker Price Improving Orders will be advantaged because they may be "non-displayed" and Market Makers may choose with whom they will trade. Finally, there is a question whether this program will in fact promote marketwide price competition if Market Maker Price Improving Orders remain dark even when offered at the minimum price variation. Requiring Market Makers in penny series to be "lit" at the existing NBBO and affording priority to hidden Price Improving Orders only at the mid-point does little to promote true competition beyond what already exists. Accordingly, PHLX would appreciate a better understanding of the basis for BATS' statement above.

For these reasons, NASDAQ urges that BATS clarify its proposal to answer these questions, or that the Commission answers them in any order approving the BATS Exchange Proposal.

Respectfully submitted,

Thomas S Witt

Tom Wittman

cc: The Hon. Mary L. Schapiro, Chairman
The Hon. Kathleen L. Casey, Commissioner
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
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