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CBOE
CHICAGO BOARD OPTIONS EXCHANGE

December 28, 2010

Via Electronic Mail

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

Re: Release No. 34-63403; File No. SR-BATS-2010-034

Dear Ms. Murphy:

The Chicago Board Options Exchange, Incorporated ("CBOE") is commenting in response to a proposed rule change submitted by BATS Exchange, Inc. ("BATS") that would amend its options rules to revise its definition of Price Improving Orders and to adopt new procedures for a Directed Order Program (Securities Exchange Act Release No. 63403 (December 1, 2010), 75 FR 76059 (December 7, 2010)(SR-BATS-2010-034). CBOE believes that certain aspects of the proposal are inconsistent with past precedent in the options markets and may adversely impact the options marketplace. We also believe the proposal contains certain ambiguities that make it difficult to have a full and fair opportunity for comment.

Overview of the Proposal

BATS has an existing order type, called Price Improving Orders ("PIO"), which allows users to submit buy/sell interest with two price points: a displayed price and a non-displayed price. The non-displayed price can be in an increment as small as $0.01. This order type, which is substantially similar to CBOE's Penny Price Improvement Process (CBOE Rule 6.13B), allows users to post non-displayed penny increment interest in classes trading with a $0.05 minimum increment. For example, in a $0.05 increment class with a 1-1.10 NBBO quote, a user could submit a PIO buy order with a displayed price of 1 and a non-displayed price of 1.03. A marketable sell order submitted to BATS would trade against the non-displayed interest at 1.03 thereby receiving price improvement above the NBBO.

BATS now proposes to expand on this offering in several ways. First, BATS proposes to allow the non-displayed portion of PIOs to be submitted using the NBBO midpoint as the designated price point. This means that executions would occur, both in penny and non-penny classes, in sub-penny increments.

Second, BATS is proposing to adopt a directed order program. Key to this program is the creation of a modified PIO that would be available only to BATS Market Makers called Market Maker Price Improving Orders ("MMPIO"). Like the proposed modified PIO, a MMPIO also would have two price points (displayed and non-displayed), and the non-displayed portion could be designated in a penny increment or a midpoint increment. However, unlike the PIO, the non-displayed portion of the MMPIO would only be available to orders directed to that particular market maker from senders specifically identified to BATS by the market maker. Further, unlike with PIOs, the BATS system would not file and update MMPIOs in its non-displayed book, instead the non-displayed portion of MMPIOs would only be "activated" upon receipt of a qualifying order directed to the market maker.

The last aspect of the proposal is the creation of Directed Orders. As discussed above, a Directed Order would be sent by a BATS Options Members to trade at an improved non-displayed price against a directed market maker. The directed market maker would only trade against a Directed Order if the market maker was quoting at the NBBO at the time BATS received the Directed Order, and the directed market maker would have to yield priority to any other interest in the BATS book at the non-displayed price.

CBOE's Comments on the Proposal

1. Sub-penny trading in the equities market is controversial. Indeed, the Sub-Penny Rule portion of Regulation NMS, which placed limits on sub-penny quoting and trading in equities, was proposed and reproposed by the Commission as part of the Regulation NMS rulemaking process and received a multitude of comments from industry participants. Additionally, sub-penny trading was already occurring in the equities market before the Sub-Penny Rule was adopted. Here, because all listed options trade on exchanges (as opposed to non-exchange venues which exist in the stock marketplace), no options may quote or trade in sub-pennies. Despite the extensive comment and review process afforded to sub-penny trading in the equities market, sub-penny quoting/trading in the options market would be introduced practically overnight via an SRO rule filing that was noticed for comment for a few weeks.

In the statutory basis section of the BATS proposal, BATS claims that the existence of sub-penny midpoint pricing in the equities market justifies its existence in the options market. However, BATS fails to consider that, unlike stock trading at the time of the adoption of Regulation NMS, options do not trade in sub-pennies. Indeed, many options do not even trade in penny increments. Minimum quoting and trading increments have powerful market structure and operational ramifications and the consideration of sub-penny pricing in options should be extremely measured and comprehensive. CBOE believes that it is inappropriate to introduce sub-penny pricing in the options market without more comprehensive study by the Commission and industry participants.

2. CBOE's Penny Price Improvement Program was geared toward option classes trading in $0.05 and $0.10 minimum increments. Based on SEC staff feedback during the rulemaking process, CBOE Rule 6.13B expressly provides that the penny pricing program is only available in "classes or series that are not already quoted in one-cent increments". The new BATS proposal has no such limitation. Thus, it appears that BATS users (particularly BATS market makers using MMPIOs) could submit non-displayed prices in penny increments even in classes that are already trading in a one-cent increment. BATS should be required to modify its PIO and MMPIO rules to provide that the non-displayed portion of such orders may only be submitted in penny increments in classes that are trading in $0.05 and $0.10 minimum increments.

3. It is unclear whether the non-displayed portion of a PIO will trade if the displayed portion of that PIO is NOT on the NBBO. It seems (although it could be clearer) that the displayed portion of a PIO must be originally entered at the NBBO, but to the extent the NBBO moves to a better price (while the displayed portion of the PIO remains unchanged) will the non-displayed portion still trade with inbound orders? The answer to this question will affect how often a PIO will actually achieve priority over a MMPIO.

4. The filing states "[w]hile BATS' directed order program requires BATS Options Market Makers to be quoting at the NBB or NBO to be eligible to trade with an incoming Directed Order directed to it, in contrast to prior rules approved by the Commission, BATS' proposed directed order program provides no participation guarantees that could negatively impact quote competition. By not providing such guarantees, BATS's proposed directed order program provides incentives to BATS Options Market Makers as well as all other BATS Options Members to aggressively quote, both at the NBBO and at non-displayed prices better than the NBBO."

The participation guarantees mentioned by BATS only apply after all customer interest at the execution price is filled. Thus, unlike on BATS market, public customers have priority. We believe BATS' statement that participation guarantees negatively impact quote competition is interesting given that BATS is proposing to allow market makers as well as users with the technological means to submit orders with displayed and non-displayed price points to establish less-than-transparent priority over public customer orders resting in the BATS book. What exactly is the incentive to quote on BATS when sophisticated users can establish priority over the displayed book by a penny or sub-penny? *This question becomes more important if BATS implements make-take fees for executions against non-displayed interest. If a trade occurs a ½ penny better than the displayed price but the liquidity taker is charged a hefty taker fee, is it really price improvement and aggressive quoting?* Thus, we question the validity of BATS statutory justification for the filing in light of the fact that the anticipated fees for directed order executions are unknown.

5. The filing states "...the Commission has previously approved rules that permit a specialist or market maker to determine the firms from which it will accept directed or preferenced orders...the Commission has implicitly approved such processes in the options market by allowing certain price improvement auctions to exist pursuant to pilot programs, which auctions provide the ability of an options member to submit a customer order along with a

contra-side principal order from the option member into a brief price improvement auction in which all members have the ability to compete for execution. BATS' proposed rule changes are similar in nature to these price improvement auctions..." We disagree. The auctions on other exchanges referenced by BATS in the filing do not allow the contra-order to be for the account of a market maker in the relevant class, while the BATS proposal is clearly geared toward market makers.

If BATS actually intended to reference the directed order program on BOX (which entails a PIP but is a distinct program, and rule, from the PIP program), we understand the BOX directed order program to currently preclude a market maker's ability to instruct the BOX system to systematically only allow directed orders from pre-designated order senders. Thus, despite BATS' representation in the filing that its proposal is similar in nature to these auctions, the BATS proposal goes beyond established practice.

6. While safeguard rule language is in place regarding preventing BATS market makers from adjusting quotes in anticipation of a pending directed order, we are not aware of any safeguards in BATS existing or proposed rules that would preclude a user from crossing two non-displayed orders (*e.g.* midpoint buy and sell orders submitted a second apart) without any semblance of transparency. Commission staff has acted previously to prevent non-displayed all-or-none orders from being used as crossing vehicles, CBOE hopes the staff will take a similar approach here.

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Consistent with the comments provided above, CBOE respectfully requests that the Commission not approve BATS' proposed rule change. BATS has not sufficiently justified the hasty introduction of sub-penny pricing in a marketplace that does not fully trade in penny increments. Further, to the extent that ambiguities in the filing are clarified, we believe additional opportunity to comment should be offered. If you have any questions regarding this letter, please contact Joanne Moffic-Silver, General Counsel, at 312-786-7462, or me at 312-786-7464.

Sincerely,

Angelo Evangelou

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cc: Robert Cook, Division of Trading and Markets
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