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January 3, 2011

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

**Re: SR-BATS 2010-34; Dark Order Types and Internalization in the Listed-Option Markets**

Dear Ms. Murphy:

LiquidPoint, LLC ("LiquidPoint")[1] appreciates the opportunity to comment on the recent rule filing referenced above and the effect upon the listed-option markets.

The referenced rule filing and others (including SR-ISE-2010-73, SR-NYSEArca-2010-90 & 2010-80, SR-NYSEAmex-2010-87) continue the assault on transparent price discovery in the listed-option markets. This filing uses "dark" order types that have undisplayed prices to obscure the true market; coupled with selected access to better prices (via directed orders) which creates a two-tiered market structure and allows for order internalization without price discovery from the broader marketplace. Specifically, this rule filing expands upon an existing order type and creates two new order types.

[1] LiquidPoint, a wholly owned subsidiary of BNY ConvergEx Group, LLC, specializes in providing derivatives technology and execution solutions for U.S. listed options traders, including institutional customers and other broker-dealers. LiquidPoint provides electronic direct market access to every U.S. options exchange, as well as advanced trading capabilities that include order execution, order management, order routing and optimization, quality assurance review, and a variety of reporting and books and records capabilities. ConvergEx Group is a leading provider of mission critical software and technology-enabled services to asset managers and financial intermediaries globally. Through our two business segments – Investment Technologies and Execution Solutions - - we offer an extensive array of technology solutions that support increased sophistication and operational efficiency to help drive growth, address changing regulation and compliance requirements and achieve performance goals.

This rule filing expands upon the Price Improving Order ("PIO") [Rule 21.1(d)(6)] by including an undisplayed National Best Bid or Offer ("NBBO") midpoint price which further obscures the true market and potentially requires trading in half-penny increments. The PIO and all order types with undisplayed prices prevent further price discovery at execution – there is no opportunity for participants to match or improve the price or available quantity. For example, a Market Maker attempting to provide liquidity in a particular option series uses displayed prices in other series to assess risk and determine pricing. If this market maker were able to respond to an undisplayed PIO price (perhaps via an automated auction), additional liquidity could be provided in other series.

This rule filing also creates two new order types; the Market Maker Price Improving Order ("MMPIO") [Rule 21.1(d)(13)] and Directed Orders ("DO") [Rule21.1(d)(14)]. The MMPIO functions similarly to the PIO, except the undisplayed price is <u>only available to certain market participants</u>. The provider of MMPIO undisplayed prices notifies the exchange of those participants eligible to access these "dark" prices through the use of the Directed Order. Together, these two order types implement a new market tier for favored clients that have access to better, undisplayed execution prices.

This favored market tier is distinctly different than current exchange rules regarding "preferencing" or "directing" orders. Preferenced orders give a preferred <u>allocation</u> at the final negotiated price. Directed Orders require that an automated auction be initiated to determine the final negotiated price. Participants using this DO are eligible to receive an undisplayed price better than the NBBO, without the protection of *negotiated* price discovery.

This market tier will allow greater participation by a market maker (albeit at somewhat more aggressive pricing) in certain Directed Orders – likely orders from internal or affiliated clients of the market maker. For example, a MMPIO entered at the NBBO with a penny undisplayed price improvement can be immediately followed with a DO marketable against NBBO – resulting in an execution against the MMPIO. There is no exposure to other participants; not even for the one second required at other exchanges. Perhaps other participants would have provided more than the penny price improvement in this example – if they had the opportunity.

This is a part of a continuing trend of allowing exchange members to internalize listed-option orders without full exposure to the marketplace, through processes that leave price discovery in the dark. The assertion that this proposal promotes market-wide competition because it "avoids creating participation guarantees" is preposterous. Market-wide competition requires transparency and access; neither of which occurs in the DO/MMPIO execution process. Participation guarantees are an elegant compromise necessary because of the transparency and access provided by automated auctions. As previously noted by LiquidPoint, certain exchanges provide automated auctions to provide price discovery when members have both buy and sell interests to represent in the marketplace and/or seek price improvement from a liquidity provider. These auctions bring transparency and competition by including other participants. If upon conclusion of the auction, contra-party interest at the *negotiated price* exceeds the available quantity, the member initiating the auction is still rewarded with a guaranteed percentage – generally 40%. The BATS immediate execution at undisplayed prices prevents the price discovery negotiation. These auctions provide an artful compromise among competing interests and allows for negotiated price discovery while maintaining the incentive to quote.

LiquidPoint believes that the internalization of listed-option orders does **not** benefit investors with increased liquidity and/or more favorable prices than negotiated price discovery available in automated auctions. This view is distinct from investors' experience in the equity markets. A particular equity security has a finite number of units available at any given time. The open interest for the numerous listed-option series overlaying the particular security expands and contracts as investors' risk mitigation needs change. This process can occur because there are obligated liquidity providers quoting all the related "term insurance policies" provided by the option contract. It is the relationship between the various option contracts that provides the incentive to quote – option market makers want their quote to be taken because the risks can be effectively managed using related options. This elegant and effective risk transference is being hobbled by the reduced incentive to quote all option series when listed-option exchanges encourage internalization. The equity market structure gives market participants flexibility in finding the finite liquidity of equity securities. The listed-option market is not constrained by finite liquidity when there is incentive to quote **all** series.

LiquidPoint respectfully submits that the "dark order types" in this rule proposal, which allow undisplayed *prices* (not undisplayed quantities), undermines the usefulness of quotes. Additionally, the DO/MMPIO execution process limits access to these undisplayed prices to certain participants, creating a <u>two-tiered market structure</u>. Further, this proposal allows internalization without the possibility of negotiated price discovery and should not be part of the listed-option market structure because it limits the contributions of other market participants, which in turn completely undercuts the liquidity needed for the risk mitigation role played by options. Finally, the investor who uses options will not be better served than with the existing exchange automated auctions, which provides the transparency vital to negotiated price discovery and the quoting of all option series, and allows investors to benefit from the additional liquidity and price improvement that initiates these auctions.

Sincerely,

Anthony J. Saliba
Chief Executive Officer
LiquidPoint, LLC