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OPTIONS EXCHANGE

January 20, 2011

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

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

Dear Ms. Murphy:

Boston Options Exchange Group, LLC ("BOX") appreciates the opportunity to comment on the above referenced proposed rule change ("Proposal") to create a directed order program on BATS Exchange, Inc. ("BATS"). BOX has concerns about certain aspects of the Proposal and urges the Commission to disapprove. In particular, BOX believes the Proposal would lead to excessive internalization by BATS Options Market Makers and that their ability to execute orders directed to them without those orders first being exposed to all market participants will result in less competition and less price improvement, and will negatively impact customers.

Under BATS' Proposal, a BATS' Market Maker Price Improving Order ("MMPIO") can be entered in increments as small as one penny regardless of the minimum trading increment of the option. BATS Options Market Makers will be able to internalize directed orders in options that trade in penny increments at prices that improve upon the best bid or offer by only a penny because the only orders that might gain priority would be pre-existing non-displayed orders at the midpoint of the NBBO (if the NBBO is ten cents wide, this would require another pre-existing non-displayed order that improved the NBBO by five cents). For pre-existing non-displayed interest to interfere with the Directed Order executing against the MMPIO, such pre-existing non-displayed interest would have to be from someone other than a market maker. Permitting MMPIOs to be entered at penny increments provides no real interference in the Market Maker internalizing 100% of its customer order flow.

BOX believes that permitting BATS Option Market Makers' excessive internalization of customer order flow will provide a powerful disincentive to other Market Makers aggressively quoting and posting liquidity, and causing a denigration in the overall market place. With the proposed rule change in place, other Market Makers would have little reason to strongly compete for customer order flow if BATS Options Market Makers that are able to enter MMPIOs can consistently internalize their customer orders. Over the last several years, increased competition among options exchanges has resulted in benefits such as tighter spreads, deeper liquidity, and significant price improvement for customers. All these benefits will be lost or reduced if market makers are able to internalize 100% of their customer orders – a scenario not unlikely under the BATS Proposal.

Further, an MMPIO entered at the NBBO with a non-displayed price of one penny improvement could be immediately followed with a BATS Options Member's marketable Directed Order at the NBBO, and result in an execution against the non-displayed price of the MMPIO. While BATS states that they will conduct surveillance for Market Maker's changing their quotes to match the national best bid or national best offer immediately prior to a Directed Order to the particular Market Maker, BOX believes the high probability for internalization still exists. A BATS Options Market Maker must be quoting at the NBBO or better to be able to enter an MMPIO. While BOX agrees that it would be problematic if a BATS Options Member contacted a BATS Market Maker about an upcoming Directed Order so that the Market Maker could change its quote or if a BATS Market Maker changed its quote after becoming aware of a customer order,



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BOX believes that the probability for greater internalization still exists. Regardless of communication between the BATS Market Maker and BATS Options Members, a BATS MMPIO may be followed by a marketable Directed Order that will result in an execution at the non-displayed price of the MMPIO with no exposure to other market participants. Other exchanges, including BOX, require that such an order be exposed to all market participants for at least one second. All other market participants would lose any opportunity to provide additional price improvement.

The Commission has previously required market maker price improvement orders to be exposed to all market participants before a market maker may trade such an improvement order against its own customer order. BOX believes that order exposure to all market participants enables the greatest amount of price discovery, enhances competition and transparency in a market, and additionally diffuses market maker internalization of orders. BATS' Proposal will allow its Options Market Makers to execute against directed orders they receive without those orders first being exposed to the market. Such a function would preclude all other market participants from taking the opportunity to match the order or provide price improvement. Moreover, BOX believes that it would be inconsistent for the Commission to approve the Proposal without any exposure period while continuing to scrutinize in great detail whether the existing exposure periods on other exchange auction mechanisms provide market participants with a meaningful opportunity to compete for orders. BOX believes that a lack of exposure of orders to all market participants will result in less competition for orders, and less opportunity for customers to receive price improvement.

The Commission has sought to prevent options exchanges from becoming closed proprietary crossing systems, and has reviewed proposals that have raised concerns about higher rates of internalization with a critical eye. The Commission has done well in its attempts to maintain a balance between rewarding market makers and dealer firms for the liquidity they provide the market, and fostering fair, orderly, and efficient markets that protect small investors and has stated, "[I]nternalization . . . while not unlawful in [itself], can present conflicts between the interests of brokers and the investors they represent. Moreover, internalization . . . diminish[es] the need for exchange participants to quote competitively."¹ BOX shares the Commission's concern that too much internalized order flow would reduce the order flow in the overall marketplace and negatively impact overall market quality.

Again, BOX appreciates the opportunity to submit these comments on the Proposal. Please contact me at (312) 444-6328 if you have any questions regarding this matter.

Respectfully submitted,

Tony McCormick
Chief Executive Officer

cc: Robert Cook, Director, Division of Trading and Markets
James Brigagliano, Deputy Director, Division of Trading and Markets
Heather Seidel, Associate Director, Division of Trading and Markets

¹ See Securities Exchange Act Release Nos. 34-43100 (July 31, 2000), (65 FR 48778) (August 9, 2000); 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004).