B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

No written comments were solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The Exchange has filed the proposed rule change pursuant to Section 19(b)(3)(A)(iii) of the Act [14] and Rule 19b–4(f)(6) thereunder.[15] Because the proposed rule change does not: (i) Significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative prior to 30 days from the date on which it was filed, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest, the proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Act and Rule 19b–4(f)(6)(iii) thereunder.

A proposed rule change filed under Rule 19b–4(f)(6) normally does not become operative prior to 30 days after the date of the filing.[16] However, pursuant to Rule 19b–4(f)(6)(iii),[17] the Commission may designate a shorter time if such action is consistent with the protection of investors and the public interest. The Exchange has asked the Commission to waive the 30-day operative delay so that the proposal may become operative immediately upon filing. In its filing, the Exchange notes that the proposal to add new NYSE Rule 2232 is substantially similar to the rule that the Commission approved for FINRA,[18] and the proposal conforms the Exchange's Rules with those of FINRA, in furtherance of the consolidation of the member firm regulation functions of NYSE, NYSE Amex Equities, and FINRA. Furthermore, the proposed deletion of the Rule Interpretations to NYSE Rule 346 would remove interpretations to an NYSE Rule that no longer exists and would therefore eliminate any potential confusion among members or member organizations regarding the applicability of such Rule Interpretations. For these reasons, the Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest, and designates the proposed rule change to be operative upon filing with the Commission.[19]

At any time within 60 days of the filing of such proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number SR–NYSE–2011–26 on the subject line.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number SR–NYSE–2011–26. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of the filing will also be available for inspection and copying at the NYSE's principal office and on its Internet Web site at *http://www.nyse.com.* All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–NYSE–2011–26 and should be submitted on or before July 28, 2011.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[20]

Cathy H. Ahn,

Deputy Secretary.

[FR Doc. 2011–16930 Filed 7–6–11; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–64781; File No. SR–BATS–2011–009]

Self-Regulatory Organizations; BATS Exchange, Inc.; Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval to Proposed Rule Change, as Modified by Amendment Nos. 1 and 2 Thereto, to Create, on a Six-Month Pilot Basis, a Directed Order Program

June 30, 2011.

I. Introduction

On March 16, 2011, BATS Exchange, Inc. (the ''Exchange'' or ''BATS'') filed with the Securities and Exchange Commission (''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] a proposal to establish, on a six-month pilot basis, a directed order (''Directed Order'') program on its options facility (''BATS

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[14] 15 U.S.C. 78s(b)(3)(A)(iii).

[15] 17 CFR 240.19b–4(f)(6).

[16] *Id.*

[17] 17 CFR 240.19b–4(f)(6)(iii). In addition, Rule 19b–4(f)(6)(iii) requires that a self-regulatory organization submit to the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. The Exchange has satisfied this requirement.

[18] *See* note 6, supra.

[19] For purposes only of waiving the 30-day operative delay, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. *See* 15 U.S.C. 78c(f).

[20] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

Options''). On March 24, 2011, BATS filed Amendment No. 1 to the proposed rule filing. The proposed rule change, as modified by Amendment No. 1, was published for comment in the **Federal Register** on April 1, 2011.[3] The Commission received 13 comment letters from 8 commenters on the proposal,[4] and a letter from BATS responding to the comment letters.[5] On June 2, 2011, BATS filed Amendment No. 2 to the proposed rule change.[6] The Commission is publishing this notice to solicit comments on Amendment No. 2 from interested persons, and is approving the proposal, as modified by Amendment Nos. 1 and 2, on an accelerated basis, for a six-month pilot period ending January 30, 2012.

II. Description of the Proposed Rule Change, as Modified by Amendment Nos. 1 and 2

The Exchange proposes to allow members of BATS Options (''Options Members'') to direct orders to BATS Options market makers under certain conditions. Specifically, the proposal would establish two new order types—a ''Directed Order'' and a ''Market Maker Price Improving Order'' (MMPIO). A Directed Order would be an order directed by an Options Member to one or more BATS Options market makers for possible execution against the MMPIO of the BATS Options market maker(s).[7] To direct an order to a particular BATS Options market maker, the Options Member must be on a list of eligible Options Members provided to the Exchange by the BATS Options market maker.[8]

To be eligible to receive a Directed Order, a BATS Options market maker must enter a MMPIO. The MMPIO would contain both a displayed price, as well as a better non-displayed price at which the market maker is willing to trade with a Directed Order. The MMPIO would be ranked on the BATS Options book at its displayed price. The non-displayed price would not be entered on the BATS Options book, but instead would be converted to a buy or sell order at the non-displayed price in response to a Directed Order directed to the market maker, up to the full displayed size of the MMPIO. Thus, an incoming marketable non-Directed Order would execute against the market maker's displayed quote, not its non-displayed better price. To be able to participate in an execution against a Directed Order: (i) The market maker must be quoting on BATS with a MMPIO that contains a displayed price at the NBBO at the time the Directed Order arrives on BATS; (ii) the non-displayed price of the MMPIO must be at a price better than the NBB (for sell Directed Orders) or the NBO (for buy Directed Orders) and marketable against the Directed Order;[9] and (iii) as noted above, the Directed Order must have come from an Options Member on the market maker's list of eligible Options Members.

If the above conditions in (i), (ii), and (iii) are met, and if there are no other non-displayed orders at prices equal to or better than the non-displayed price of the MMPIO, the Directed Order will trade with the MMPIO up to the full size of the MMPIO. If there are non-displayed orders on the BATS Options book at prices equal to or better than the non-displayed price of the MMPIO, those other non-displayed orders will in all cases have priority over the non-displayed price of the MMPIO. In such circumstances, the MMPIO may still execute at its non-displayed price against the Directed Order to the extent of any remaining contracts of the Directed Order. If a Directed Order is directed to more than one BATS Options market maker, such Directed Order will execute in price/time priority based on the non-displayed price of such orders, to the extent the Directed Order can execute against any MMPIO.[10]

BATS notes that, if an Options Member notifies a BATS Options market maker of its intention to submit a Directed Order so that the BATS Options market maker could change its quotation to match the NBB or NBO immediately prior to submission of the Directed Order, the parties would be engaging in conduct inconsistent with just and equitable principles of trade in violation of BATS Rules 3.1 and 18.4(f). In addition, BATS notes that a BATS Options market maker who becomes aware of a customer order from an affiliated broker-dealer or desk within the same broker-dealer and acts on such information to change its quotations to match the NBB or NBO immediately prior to submission of a Directed Order would be in violation of the BATS Rule 22.10, ''Limitations on Dealings.'' BATS represents that it will proactively conduct surveillance for such conduct and enforce against such violations.[11]

BATS proposes to establish its Directed Order program on a six-month pilot basis. BATS represents that, during the pilot period, it will study the impact of the rules and will provide the Commission with monthly reports detailing its ongoing review of the pilot. Such reports would include statistics with respect to:

• The number of Directed Orders submitted to BATS Options;

[3] *See* Securities Exchange Act Release No. 64132 (March 28, 2011), 76 FR 18280 (''Notice'').

[4] *See* Letters to Elizabeth M. Murphy, Secretary, Commission, from Jennifer M. Lamie, Assistant General Counsel, Legal Division, Chicago Board Options Exchange (''CBOE''), dated June 29, 2011 (''CBOE II Letter''); Tom Wittman, The NASDAQ OMX PHLX, Inc. and The NASDAQ Options Market (together ''Nasdaq''), dated June 24, 2011 (''Nasdaq II Letter''); Janet L. McGinness, SVP & Corporate Secretary, Legal & Government Affairs, NYSE Euronext, dated June 17, 2011 (''NYSE Euronext II Letter''); Michael J. Simon, Secretary, International Securities Exchange, LLC (''ISE''), dated June 17, 2011 (''ISE II Letter''); Anthony D. McCormick, Chief Executive Officer, BOX Options Exchange Group, LLC (''BOX'')), dated June 13, 2011 (''BOX II Letter''); Angelo Evangelou, Assistant General Counsel, Legal Division, CBOE, dated April 27, 2011 (''CBOE I Letter''); John C. Nagel, Managing Director and General Counsel, Asset Management and Markets, Citadel LLC, dated April 25, 2011 (''Citadel Letter''); Andrew Stevens, Legal Counsel, IMC Chicago, LLC d/b/a IMC Financial Markets, dated April 21, 2011 (''IMC Letter''); Janet L. McGinness, SVP & Corporate Secretary, Legal & Government Affairs, NYSE Euronext, dated April 21, 2011 (''NYSE Euronext I Letter''); Kurt Eckert, Principal, Wolverine Trading, LLC, dated April 21, 2011 (''Wolverine Letter''); Tom Wittman, Nasdaq, dated April 21, 2011 (''Nasdaq I Letter''); Michael J. Simon, Secretary, ISE, dated April 21, 2011 (''ISE I Letter''); and Anthony D. McCormick, Chief Executive Officer, BOX, dated March 29, 2011 (''BOX I Letter'').

[5] *See* Letter to Elizabeth M. Murphy, Secretary, Commission, from Jeromee Johnson, BATS, dated June 2, 2011 (''BATS Letter'').

[6] In response to comments received on the proposed rule change, as modified by Amendment No. 1 thereto, the Exchange filed Amendment No. 2 to revise the proposed rule change to permit BATS Options Members to send Directed Orders to more than one BATS Options market maker.

[7] As originally proposed, Options Members could only send Directed orders to one BATS Options market maker. In Amendment No. 2, BATS revised the proposal to permit Options Members to send Directed Orders to more than one BATS Options market maker.

[8] BATS Rule 21.1(d)(14).

[9] The non-displayed price also must be at least one cent better than the NBB or NBO, as applicable.

[10] *See* Amendment No. 2.

[11] One commenter on the proposal believes that the proposed rule change does not address whether it would be permissible for a BATS Options market maker to share the details of its MMPIO, whether existing or prospective, with an order flow provider (affiliated or otherwise) so that the order flow provider could make routing decisions based on this information. *See* NYSE Euronext I Letter at 5–6. If a BATS Options market maker informs an order entry firm of its intention to modify its quotation or details about its MMPIO so that the BATS Options Member could send a Directed Order to the BATS Options market maker, BATS would view this as pre-arranged trading and would consider this to be a violation of BATS Rules 3.1 (just and equitable principles of trade) and 18.4(f) (misuse of material non-public information). *See* E-mail to David Hsu, Assistant Director, Division of Trading and Markets, Commission, from Anders Franzon, BATS, dated June 27, 2011. If the order entry firm was an affiliate or a desk within the same firm as the BATS Options market maker, and the BATS Options market maker shared information regarding its planned quoting activities or details about the market maker's MMPIO, then BATS would consider this to be a violation of BATS Rule 22.10 (Limitation on Dealings). *Id.*

- The number of MMPIOs submitted to BATS Options;
- Information regarding the types of market participants that sent Directed Orders;
- The number of Market Makers that participated in the directed order program;
- The percentage of time that Market Makers participating in the directed order program were at the NBBO when a Directed Order arrived at BATS Options;
- The number of orders, excluding MMPIOs, against which an incoming Directed Order executed;
- The proportion of each Directed Order that was executed against a MMPIO;
- The percentage of Directed Orders that received price improvement over the NBBO;
- The average amount of price improvement for Directed Orders; and
- Data related to the quality of the best bid and offer on BATS Options.

III. Summary of Comments

The Commission received 13 comment letters from 8 commenters opposing the proposal.[12] These commenters generally argue that, because Directed Orders will not be exposed to meaningful competition, the proposal will disincent market makers from quoting aggressively and negatively impact the price at which the Directed Orders are executed.[13]

Several commenters argue that the lack of a requirement that the Directed Order be exposed to all market participants or be subject to a separate auction mechanism will prevent other market participants from any opportunity to provide further price improvement to the Directed Order, and thus harm the Directed Order.[14] Several commenters argue that other market participants will not be able to effectively compete with a BATS Options market maker with a MMPIO because, although other market participants also can enter orders that have a non-displayed price on the BATS book at a price equal to or better than the non-displayed price of the MMPIO,[15] that non-displayed price would be at risk to all incoming marketable orders, not just Directed Orders from a select list of eligible customers.[16] Commenters further argue that other market participants are at a further competitive disadvantage *vis-à-vis* BATS options market makers with MMPIOs in one cent MPV options because BATS Options market makers would be able to enter MMPIOs with non-displayed prices in penny increments, but other market participants could not enter orders with non-displayed prices in penny increments.[17] Several commenters argue that BATS Options market makers will be able to enter MMPIOs with better non-displayed prices than other competing market participants, thus effectively resulting in 100 percent internalization of Directed Orders (assuming the participating market maker is always willing to provide prices better than the NBBO) without the opportunity for exposure.[18] In addition, a few commenters argue that price discovery will be negatively impacted by the perpetuation of a two-tiered market for customers—one market reflecting publicly available prices and sizes, and another market reflecting a non-public pool of liquidity available for only certain approved customers.[19]

In response to commenters, BATS countered that certain order flow sending firms today have order flow, which by its very nature, is more valuable to some market participants than the flow of other order flow sending firms.[20] BATS notes market makers already retain the discretion to pay certain firms non-transparent payment for order flow amounts.[21] BATS asserts that its 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.[22] According to BATS, the proposal puts in place a structure by which *all* members can both compete for that flow by contributing to price and size discovery for the entire market and reward that flow with price improvement above and beyond the NBBO.[23]

Further, BATS notes that BATS Options market makers must enter orders that assume the risk of trading with all participants at NBBO, and must commit to price improvement over the NBBO without knowing the details of the particular order and being guaranteed an allocation.[24] BATS notes that other directed order programs on other exchanges do not impose this

[12] *See supra* note 4. In addition, the Commission notes that in response to an earlier Directed Order proposal filed and later withdrawn by the Exchange (SR–BATS–2010–034) that was substantially similar to the instant proposal (the ''Prior Proposal''), one commenter had stated that the proposal would be beneficial to retail investors by providing firms with competitive opportunities to seek price improvement on client option orders. *See* Letter to Elizabeth M. Murphy, Secretary, Commission, from Christopher Nagy, Managing Director, Order Strategy, TD Ameritrade, dated December 23, 2010 (''Ameritrade Letter'').

[13] *See* BOX I Letter at 1; BOX II Letter at 1–2; CBOE I Letter at 2; Citadel Letter at 2; IMC Letter at 2; ISE I Letter at 3; ISE II Letter at 3; Nasdaq I Letter at 3; NYSE Euronext I Letter at 3; NYSE Euronext II Letter at 4; and Wolverine Letter at 1.

[14] *See* BOX I Letter at 1–2; CBOE I Letter at 2–3; CBOE II Letter at 3–5; IMC Letter at 2; ISE I Letter at 4; Nasdaq I Letter at 3; NYSE Euronext I Letter at 4, and NYSE Euronext II Letter at 3–4. *See also* BOX II Letter at 2 (arguing that, if BATS Options market makers receive Directed Orders from only their list of eligible Options Members, the ''cost of that enjoyment should be the requirement that directed orders be exposed on the market or subject to a specific auction mechanism so that customers enjoy the greatest amount of opportunity for price improvement'') and IMC Letter at 2 (stating that the structure of the BATS Directed Order program ''unduly limits competition as such does not contribute to price discovery.''). In addition, BOX states that, because the proposal permits only BATS Options market maker(s) designated by the Options Member to compete for the Directed Order, and such designation is at the discretion of the Options Member, a ''substantial conflict of interest may arise,'' incenting BATS Options market makers to significantly increase payment for order flow payments so that they can be the sole destination for the Option Member's customer orders. *See* BOX II Letter at 1–2. This commenter also argues that, although the rule would allow an Options Member to submit Directed Orders to multiple BATS Options Market Makers, competition for the order is still limited because the order would be exposed to some—but not all—market participants. *See* BOX II Letter at 1–2.

[15] In options with a five or ten cent minimum price variation (''MPV''), other market participants would be able to enter a non-displayed price using a Price Improving Order to compete with MMPIOs for Directed Orders. A Price Improving Order would receive priority over MMPIOs at the same non-displayed price. However, the non-displayed price of a Price Improving Order would be available to all incoming marketable orders, in contrast to the non-displayed price of an MMPIO, which would only be available to incoming Directed Orders.

[16] *See, e.g.,* CBOE I Letter at 2; CBOE II Letter at 4; Citadel Letter at 2; IMC Letter at 2; ISE I Letter at 3; ISE Letter II at 1–2; Nasdaq I Letter at 2, Nasdaq II Letter at 1, and NYSE Euronext II Letter at 4.

[17] *See* CBOE I Letter at 2; CBOE II Letter at 2; Citadel Letter at 2; IMC Letter at 2; and Nasdaq I Letter at 2. These commenters believe that, because the orders of these market participants would be displayed in options with a one cent MPV, they would be at greater risk of being executed against informed order flow. On the other hand, because MMPIOs may be entered in increments as small as one cent and are not displayed, BATS Options market makers with MMPIOs are not subject to the same risk. *Id. See also* NYSE Euronext II Letter at 4.

[18] *See* Citadel Letter at 2–3; Nasdaq I Letter at 2–3; and Nasdaq II Letter at 2.

[19] *See* Citadel Letter at 2; ISE I Letter at 2; and Wolverine Letter at 2. *See also* CBOE I Letter at 3 and CBOE II Letter at 2, wherein CBOE argues that the MMPIO is inconsistent with Rule 602 of Regulation NMS, 17 CFR 242.602 (the ''Quote Rule''), because the BATS proposal would only require the MMPIO to be firm for pre-selected Directed Order participants (as opposed to all incoming interest received by BATS).

[20] *See* BATS Letter at 6–7.

[21] *See* Notice, *supra* note 3, at 18283.

[22] *Id.*

[23] *See* BATS Letter at 6–7.

[24] *See* BATS Letter at 3–4.

requirement to provide price improvement.[25] In addition, BATS argues that by not providing allocation guarantees, the proposed Directed Order program provides incentives to BATS Options market makers as well as Options Members to aggressively quote, both at the NBBO and at non-displayed prices better than the NBBO.[26]

Several commenters state that, because Directed Orders on BATS are not exposed to all market participants, BATS Options market makers will not be motivated to offer more than the minimum amount of price improvement ($0.01) to a customer.[27] In its response letter, BATS states that the proposed rule does not cap the price improvement opportunities available to Options Members in the price-time priority market of BATS Options; rather the proposed rule merely provides a minimum amount of price improvement that must be offered to a Directed Order.[28] Another commenter, however, argues that although the BATS proposal does not cap price improvement, the lack of competition at the non-displayed prices combined with the burden of quoting at the NBBO will depress the amount of price improvement offered by BATS Options market makers.[29]

Commenters further argue that the proposal will disincent market makers that do not have arrangements with Options Members from aggressively quoting and posting liquidity.[30] According to one of these commenters, BATS Options market makers to whom orders are not directed would have little to no incentive to quote at the NBBO because they would not be rewarded with trade executions, as Directed Orders would execute against non-displayed interest one increment better rather than the NBBO.[31] Another commenter also contends that, if the proposed rule change is approved, market participants that do not receive Directed Orders would be forced to quote less aggressively to account for adverse selection because MMPIOs would cherry-pick the most desirable order flow from the market with private hidden quotes.[32] As a result, according to this commenter, market liquidity would be damaged and average publicly quoted spreads would widen in some options contracts, particularly those that trade with wider than average spreads.[33]

Some commenters argue that the proposal would result in inferior executions for customer orders when a BATS Options market maker with a MMPIO at the best price is not selected by an Options Member to receive its Directed Order.[34] One of these commenters argues that the proposal is inconsistent with the Act because, if two MMPIOs have different non-displayed prices, a Directed Order could be directed to the MMPIO with the inferior price, resulting in a trade-through of a better price that is available to other participants.[35] BATS acknowledges that this factual scenario could be the case, but states that in the same way that the Directed Order proposal empowers BATS Options market makers to select which order flow providing firms to whom they wish to offer price improvement for the customers of that firm, the proposal also empowers Options Members to select which market making firms they wish to preference.[36] BATS believes that this is an important distinction that provides Options Members with competitive opportunities to seek price improvement on customer orders.[37] Further, BATS has amended its proposal to clarify that Options Members can enter into arrangements with, and elect to direct an order to, multiple market makers.[38] In such case, the incoming Directed Order would execute against the Directed Order market maker with the best non-displayed price (assuming that the Directed Order would execute against an MMPIO).

IV. Discussion and Commission Findings

After careful consideration of the proposal and the comments received, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange[39] and, in particular, the requirements of Section 6 of the Act.[40] Specifically, the Commission finds that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act,[41] which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest and are not designed to permit unfair discrimination between customers, issuers, brokers or dealers.

The Commission notes that the proposed rule change is designed to enhance opportunities in the market for BATS Options market makers to provide, and Options Members to obtain, price improvement for their customer orders. Specifically, to be eligible to trade with a Directed Order, the proposal requires a BATS Options market maker to have entered a MMPIO with a displayed price equal to the NBB (for sell Directed Orders) or the NBO (for buy Directed Orders), as well as a non-displayed price at least one cent better than the NBB or NBO, as applicable.[42] Thus, the Directed Order would receive price improvement over the NBB or NBO, as applicable. However, as discussed above, commenters expressed concern that the lack of exposure of the Directed Orders would negatively impact quote competition and deny other market participants meaningful opportunities to provide further price improvement to a Directed Order.[43]

The Commission has carefully considered the arguments expressed by

[25] *Id.*

[26] *See* Notice, *supra* note 3, at 18282.

[27] *See* BOX I Letter at 2; NYSE Euronext I Letter at 4 and NYSE Euronext II Letter at 4. *See also* Citadel Letter at 2.

[28] *See* BATS Letter at 6.

[29] *See* ISE II Letter at 2–3.

[30] *See* BOX I Letter at 1 and Wolverine Letter at 1. *See also* BOX II Letter at 2 (arguing that the high probability that an Options Member will designate only one BATS Options market maker to receive a Directed Order will mean internalization rates are likely to reach 100 percent and have the ''additional effect of discouraging competition on the regular order book across all of the options market, resulting in further degradation of NBBO spreads, to the detriment of all customers.''); ISE Letter at 6 (stating that the lack of competition for a Directed Order would result in a 100 percent execution guarantee for BATS Options market makers, which would be a significant departure from Commission policy that limits the level of allocation guarantees at 40 percent of the order to assure that such guarantees do not remove the incentive for other market participants to compete); NYSE Euronext II Letter at 5 (arguing similarly).

[31] *See* Wolverine Letter at 1.

[32] *See* Citadel Letter at 2.

[33] *See id.*

[34] *See* BOX II Letter at 2; Nasdaq I Letter at 1; Nasdaq Letter II at 2–3; NYSE Euronext I Letter at 2; and NYSE Euronext II Letter at 5.

[35] *See* Nasdaq I Letter at 1. *See also* NYSE Euronext II Letter at 5.

[36] *See* BATS Letter at 4–5.

[37] *See id.*

[38] *See* Amendment No. 2.

[39] In approving this proposed rule change the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[40] 15 U.S.C. 78f.

[41] 15 U.S.C. 78f(b)(5).

[42] BATS Rule 21.1(d)(13).

[43] *See supra* notes 14–33 and accompanying text.

commenters and by the Exchange. The Commission recognizes the concerns expressed and the difficult issues involved. The Commission believes that order exposure generally is beneficial to options markets in that it provides an incentive to options market makers to provide liquidity and therefore plays an important role in ensuring competition in the options markets.[44] The Commission also recognizes, however, the importance of providing effective opportunities for customer order flow in listed options to receive executions at prices better than the NBBO. In evaluating the proposal, the Commission has weighed the relative merits of each for the options markets.

On the options markets, specialists and market makers often compete for order flow by offering cash or non-cash inducements, known as payment for order flow (''PFOF''),[45] to brokers to send their orders to a particular market maker or exchange.[46] PFOF arrangements are prevalent in today's market.[47] These arrangements likely impact the incentives for market makers (or others) to quote aggressively to trade with order flow covered by such PFOF arrangements because market participants know that the market makers will be able to trade with some or all of the captured order flow as long as they match the NBBO (whether by displaying quotes that match the NBBO set by others or by matching better quotes elsewhere pursuant to mechanisms that provide market makers with the opportunity to step-up and trade with orders that are exposed for one second).

The BATS proposal offers an alternative mechanism to enable market makers to compete for order flow by providing better prices directly to customers[48] rather than through payments to the customer's broker.[49] The proposal allows market makers to differentiate between orders from traders that are relatively more informed about the short-term direction of prices (*e.g.,* professional traders) and orders from less informed traders (*e.g.,* retail investors). In this way, it may enable BATS Options market makers to provide better prices to less informed order flow that they otherwise would not be willing or able to provide if they had to make those prices available to all incoming order flow.[50] The Commission recognizes that other exchanges have adopted different mechanisms that include an order exposure element to provide price improvement to customer orders.[51] The Commission questions, however, the extent to which these mechanisms are utilized. In the context of this options market structure, the Commission believes that the proposal to provide an alternative mechanism for BATS options market makers to provide executions for customer orders at prices better than the NBBO is consistent with the Act.[52]

In response to commenters' concerns that the proposal would perpetuate a two-tiered market for customers—one market reflecting publicly available prices and sizes, and another reflecting a non-public pool of liquidity available for only certain approved customers[53]—the Commission notes that the Act does not prohibit exchange members or other broker-dealers from discriminating among customers, so long as their activities are not otherwise inconsistent with the federal securities laws.[54] The Commission also notes that the Act does not require exchanges to preclude discrimination by broker-dealers. Indeed, the Commission notes that broker-dealers commonly differentiate between customers based on the nature

[44] *See* Securities Exchange Act Release No. 63955 (February 24, 2011), 76 FR 11533 at 11540 (March 2, 2011) (SR–ISE–2010–73).

[45] The Commission has defined PFOF broadly as ''any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration to a broker or dealer from any broker or dealer, national securities exchange, registered securities association, or exchange member in return for the routing of customer orders by such broker or dealer to any broker or dealer, national securities exchange, registered securities association, or exchange member for execution, including but not limited to: research, clearance, custody, products or services; reciprocal agreements for the provision of order flow; adjustment of a broker or dealer's unfavorable trading errors; offers to participate as underwriter in public offerings; stock loans or shared interest accrued thereon; discounts, rebates, or any other reductions of or credits against any fee to, or expense or other financial obligation of, the broker or dealer routing a customer order that exceeds that fee, expense or financial obligation.'' 17 CFR 240.10b–10(d)(9).

[46] Under a typical payment for order flow arrangement, a specialist or market maker offers an order entry firm cash or other economic inducement to route its customer orders to that specialist's or market maker's exchange because the specialist or market maker knows it will be able to trade with a portion of all incoming orders, including those from firms with which it has payment for order flow arrangements. For further discussion of PFOF and its impact on the options markets, *see* Securities Exchange Act Release No. 49175 (February 3, 2004), 69 FR 6124 (February 9, 2004).

[47] Reports under Rule 606 of Regulation NMS indicate that nearly all retail broker-dealers participate in PFOF arrangements. Regulation NMS Rule 606 reports posted by broker-dealers for the fourth quarter of 2010 indicate PFOF amounts that generally are around $0.30 per contract and can range up to $0.85 per contract.

[48] *See also* discussion of Ameritrade Letter on the Prior Proposal, *supra* note 12.

[49] The Commission views the BATS proposal as an alternative mechanism to PFOF, as it provides a means to benefit customers directly through price improvement, rather than the customer's broker through PFOF. The Commission is approving the BATS proposal in the context of the existence of PFOF arrangements in the options markets. Should such arrangements no longer be present in the options market, the Commission expects the Exchange to re-evaluate, and the Commission may re-evaluate, whether the Directed Order program is appropriate.

The Commission acknowledges, however, that the BATS proposal does not preclude an Options Member from separately entering into a PFOF arrangement with a BATS Options market maker but believes that, even if such arrangements occur, executions occurring pursuant to this proposal would receive prices better than the NBBO, thus providing a direct benefit to customers in the form of price improvement.

[50] It is well known in academic literature and industry practice that prices tend to move against market makers after trades with informed traders, often resulting in losses for market makers. *See* Stoll, H. R., ''The supply of dealer services in securities of markets,'' *Journal of Finance* 33 (1978), at 1133–51; Glosten, L. and P. Milgrom, ''Bid ask and transaction prices in a specialist market with heterogeneously informed agents,'' *Journal of Financial Economics* 14 (1985), at 71–100; and Copeland, T., and D. Galai, ''Information effects on the bid-ask spread,'' *Journal of Finance* 38 (1983), at 1457–69. Thus, there is a strong economic rationale for market makers not providing informed traders price improvement. Uninformed investors end up bearing the cost of these market maker losses through wider spreads that market makers need to quote to uninformed investors due to informed order flow. *Id.*

[51] The Commission notes that market makers on two other exchanges are not required to provide price improvement to Directed Orders using their price improvement auctions, whereas the BATS Directed Order program requires that a BATS Options market maker provide price improvement when entering the MMPIO over the NBBO to be able to trade with the Directed Order. *See* BOX Rules, Chapters V, Section 18 (The Price Improvement Period) and VI, Section 5(c) (Obligations of Market Makers) and ISE Rules 723 (Price Improvement Mechanism for Crossing Transactions) and 811 (Directed Orders). The Commission further notes that orders are not exposed for possible price improvement on other exchanges with ''preferenced'' order programs. Under the ''preferenced'' order programs on other exchanges, orders are sent to certain market makers, who, if quoting at the NBBO at the time the preferenced order is received, are guaranteed up to 40% of the order at that price, after resting customer orders at that price, if any, are executed. *See, e.g.,* CBOE Rule 8.13; ISE Rule 713, Supplementary Material .03; NYSE Amex Rule 964NY and 964.1NY.

[52] In response to comments that, because Directed Orders on BATS are not exposed to all market participants, BATS Options market makers would not be motivated to offer more than the minimum amount of price improvement to a customer, the Commission notes that, under the proposed rule, as amended, an Options Member may encourage competition for its Directed Orders by submitting them to more than one BATS Options market maker that has put that member on its eligible customer list, thereby potentially encouraging such market makers to provide more than a minimum amount of price improvement.

[53] *See supra* note 19 and accompanying text.

[54] The Commission further notes that it does not agree with the comment that an MMPIO is inconsistent with the Quote Rule (*see supra* note 19). An MMPIO is firm and available to all market makers at its displayed price. The non-displayed price of a MMPIO, however, is not communicated to market participants and thus is not a bid or offer for which a market maker is required to be firm pursuant to the Quote Rule.

and profitability of their business. Further, in general, investors as a class tend to have an opinion on the long-term prospects of a company, and are less informed about the intraday price movements that affect the profitability of market makers. Thus, market makers often view less informed order flow as desirable, and there is intense competition for this order flow. Allowing market makers to differentiate between customers may further encourage market makers to provide price improvement to less informed customer order flow, which would inure to the benefit of investors. One of the core principles of the Act, and Section 6(b)(5) thereof, is the protection of investors. Accordingly, the Commission does not believe that it would be inconsistent with the Act for the Exchange to provide, under the circumstances and facts set forth in this proposal, BATS Options market makers the ability to differentiate between customers in providing price improvement in the form of MMPIOs.[55]

The Exchange has proposed that the Directed Order program operate on a six-month pilot basis so that the Commission and the Exchange can monitor the effects of the pilot on the markets and investors, and consider appropriate adjustments, as necessary. To help the Commission and the Exchange evaluate the Directed Order program during the pilot, the Exchange proposes to provide to the Commission monthly data regarding price improvement and competition in the Directed Order program.[56] In addition, the Exchange has also represented to the Commission that it will provide a regulatory study regarding how it tests to determine whether the appropriate information barriers are in place to protect against an order flow provider giving a market maker advance notice of an incoming Directed Order or a BATS Options market maker providing information regarding its planned quoting activities or details about its MMPIO to an order flow provider. Approving the proposal on a pilot basis and requiring submission of monthly data will allow the Commission to analyze the Directed Order program and its impact, if any, on the marketplace.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as modified by Amendment Nos. 1 and 2, is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

• Use the Commission's Internet comment form *http://www.sec.gov/rules/sro.shtml*); or

• Send an e-mail to *rule-comments@sec.gov.* Please include File Number SR–BATS–2011–009 on the subject line.

Paper Comments

• Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number SR–BATS–2011–009. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–BATS–2011–009 and should be submitted on or before July 28, 2011.

VI. Accelerated Approval of Proposed Rule Change, as Modified by Amendment Nos. 1 and 2

Amendment No. 2 revised the proposed rule change to permit Options Members to send Directed Orders to more than one BATS Options market maker. Amendment No. 2 also amended the proposed rule change to state that if a Directed Order is directed to more than one BATS Options market maker, such Directed Order will execute in price/time priority based on the non-displayed price of such orders, to the extent the Directed Order can execute against any MMPIO. These revisions are designed to respond to certain of the commenters' concerns regarding competition in the Directed Order program and clarify aspects of the proposal. In addition, the Commission notes that the proposed revisions may encourage an Options Member to submit a Directed Order to more than one BATS Options market maker, thereby potentially encouraging such market makers to compete with respect to the amount of price improvement they provide. Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,[57] for approving the proposed rule change, as modified by Amendment Nos. 1 and 2, prior to the 30th day after the date of publication of notice in the **Federal Register**.

VII. Conclusion

It Is Therefore Ordered, pursuant to Section 19(b)(2) of the Exchange Act,[58] that the proposed rule change (SR–BATS–2011–009), as modified by Amendment Nos. 1 and 2, be, and hereby is, approved on an accelerated basis, for a pilot period ending January 30, 2012.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[59]

Cathy H. Ahn,

Deputy Secretary.

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[55] *See, e.g.,* Securities Exchange Act Release No. 64097 (March 18, 2011), 76 FR 16650 (March 24, 2011) (SR–BX–2010–079) (eliminating the anonymity of Directed Orders on a permanent basis). In its order approving a proposal to remove anonymity from the BOX Directed Order process, the Commission stated that it ''does not believe that it would be inconsistent with the federal securities laws for the Exchange to provide, under the circumstances set forth in this proposal, the means for its Market Makers to differentiate between customers in providing price improvement or other non-required advantages to certain customers.''

[56] *See supra* Section II for the statistics to be provided by the Exchange in monthly reports detailing its ongoing review of the pilot.

[57] 15 U.S.C. 78s(b)(2).

[58] 15 U.S.C. 78s(b)(2).

[59] 17 CFR 200.30–3(a)(12).