



SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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**Form 19b-4 Information (required)**

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change (required)**

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

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Exhibit Sent As Paper Document

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

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Exhibit Sent As Paper Document

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of the Proposed Rule Change

Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> BATS Exchange, Inc. (the “Exchange” or “BATS”) is filing with the Securities and Exchange Commission (“Commission”) a proposed rule change to create, on a pilot basis, new BATS Rule 21.1(d)(13), entitled “Market Maker Price Improving Orders” and new BATS Rule 21.1(d)(14), entitled “Directed Orders.” The Exchange also proposes to amend existing BATS Rule 21.1(d)(2), entitled “Price Improving Orders.”

(a) The text of the proposed rule change is below. Material proposed to be added is underlined. Material proposed to be deleted is enclosed in brackets.

\* \* \* \* \*

CHAPTER XXI. TRADING SYSTEMS

Rule 21.1. Definitions

The following definitions apply to Chapter XXI for the trading of options listed on BATS Options.

(a) – (c) (No changes)

(d) The term “Order Type” shall mean the unique processing prescribed for designated orders that are eligible for entry into the System, and shall include:

(1) – (5) (No changes)

(6) “Price Improving Orders” are orders to buy or sell an option at a specified price at an increment smaller than the minimum price variation in the security. Price Improving Orders may be entered in increments as small as (1) one cent. Price Improving Orders [that are available for display shall] will be displayed at the minimum price variation in that security and shall be rounded up for sell orders and rounded down for buy orders. Unless a User has entered

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

instructions not to do so, Price Improving Orders will be subject to the “displayed price sliding process.” Pursuant to the displayed price sliding process, a Price Improving Order that after rounding to the minimum price variation, or any other order to be displayed on the BATS Options Book that at the time of entry, would lock or cross a Protected Quotation (collectively, “the original locking price”):

(A) such order will be displayed by the System at one minimum price variation below the current NBO (for bids) or to one minimum price variation above the current NBB (for offers); and

(B) in the event the NBBO changes such that the order at the original locking price would not lock or cross a Protected Quotation, the order will receive a new timestamp, and will be displayed at the original locking price.

(7) – (12) (No changes)

(13) “Market Maker Price Improving Orders” are orders submitted by registered BATS Options Market Makers to buy or sell an option that have a displayed price and size, as well as a non-displayed price at which the BATS Options Market Maker is willing to trade with a Directed Order. The non-displayed price of a Market Maker Price Improving Order may be entered in increments as small as (1) one cent. Market Maker Price Improving Orders will be ranked on the BATS Options Book at their displayed price. The non-displayed price of a Market Maker Price Improving Order is not entered into the BATS Options Book but is, along with the displayed size, converted to a buy or sell order at its non-displayed price in response to a Directed Order directed to the BATS Options Market Maker. If the Directed Order is marketable against the non-displayed price of the Market Maker Price Improving Order, the Market Maker Price Improving Order will execute against a Directed Order directed to the BATS Options Market Maker up to the full displayed size, and at the non-displayed price, of the Market Maker Price Improving Order, so long as the following conditions are satisfied:

(A) at the time the Directed Order arrives to the Exchange, the displayed price of the Market Maker Price Improving Order is equal to the NBB (for sell Directed Orders) or the NBO (for buy Directed Orders), and

(B) there are no other orders on the BATS Options Book at prices equal to or better than the non-displayed price of the Market Maker Price Improving Order. If there are other non-displayed orders on the BATS Options Book at prices equal to or better than the non-displayed price of the Market Maker Price Improving Orders, those other non-displayed orders will in all cases have priority over the non-displayed price of the Market Maker Price Improving Order. In such circumstances, the Market Maker Price Improving Order may still execute at its non-

displayed price against the Directed Order consistent with the price/time priority provisions of Rule 21.8 to the extent of any remaining contracts of the Directed Order.

(14) “Directed Orders” are orders from a BATS Options Member that are directed to a particular BATS Options Market Maker for execution. Directed Orders will be eligible to trade at a price better than the NBB or NBO with the BATS Options Market Maker to whom the Directed Order is directed if the BATS Options Member submitting the Directed Order has been permitted by the particular BATS Options Market Maker to submit Directed Orders to the BATS Options Market Maker, and the particular BATS Options Market Maker has posted a Market Maker Price Improving Order on the BATS Options Book in the security that has a displayed price equal to the NBB (for sell Directed Orders) or the NBO (for buy Directed Orders) at the time the Directed Order arrives to the Exchange. If these conditions are not met, the Directed Order will be processed on the Exchange, consistent with the terms of the Directed Order, in compliance with the order display and book processing provisions of BATS Rule 21.8 and, as applicable, with the order routing provisions of BATS Rule 21.9.

(e) – (g) (No changes)

\* \* \* \* \*

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The proposed rule change was approved by the Board of Directors of the Exchange on November 19, 2010. No other action is necessary for the filing of the rule change.

Questions regarding this rule filing may be directed to Eric Swanson, Senior Vice President and General Counsel of the Exchange at (913) 815-7000.

3. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change.

(a) Purpose

The Exchange is proposing certain modifications and additions to its rules related to the trading of options. First, the Exchange is proposing the establishment of new Rule

21.1(d)(13), entitled Market Maker Price Improving Orders. Second the Exchange is proposing the establishment of new Rule 21.1(d)(14), entitled Directed Orders. Third, the Exchange is proposing to modify the text of Rule 21.1(d)(6), entitled Price Improving Orders, to make a clarifying change.<sup>3</sup>

The Exchange is proposing the rule changes described below to establish a directed order program through which members of BATS Options (“Options Members”) can direct an order to a particular BATS Options Market Maker for potential execution at a price improved over the existing National Best Bid (“NBB”) or National Best Offer (“NBO”). As part of this program, BATS is proposing to define two new order types. The first would be new Rule 21.1(d)(13), entitled Market Maker Price Improving Orders, which are orders from a BATS Options Market Maker to buy or sell an option that has a displayed price and size and a non-displayed price at which the BATS Options Market Maker is willing to trade with a Directed Order. As proposed, a Market Maker Price Improving Order would be ranked on the BATS Options Book at its displayed price. The non-displayed price of the Market Maker Price Improving Order would not be entered into the BATS Options Book, but would be, along with its displayed size, converted to a

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<sup>3</sup> The Exchange previously filed a proposal to establish a directed order program for BATS Options. See Securities Exchange Act Release No. 63403 (December 1, 2010), 75 FR 76059 (December 7, 2010) (SR-BATS-2010-034) (notice of filing of directed order program proposal). The Exchange withdrew its original filing in its entirety and has re-filed this proposal to address comments received on the proposal by eliminating the originally proposed midpoint order functionality, to provide additional clarity in a few areas, and to propose operation of the directed order program on a pilot basis. In a manner consistent with this filing, the Exchange also responded to comments received on the original proposal. See Letter from Eric J. Swanson, Secretary, BATS Exchange, Inc. to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission dated February 24, 2011.

buy or sell order at its non-displayed price in response to a Directed Order directed to the BATS Options Market Maker. For the avoidance of doubt, the Exchange reiterates that, as proposed, the full displayed size of a Market Maker Price Improving Order, and only the full *displayed size* of a Market Maker Price Improving Order, is available to trade with a Directed Order directed to a BATS Options Market Maker. Key to the structure of the proposal is that it creates incentives for *displayed* price and size discovery available to all market participants.

The second new order type proposed would be new Rule 21.1(d)(14), entitled Directed Orders, which are orders from a BATS Options Member that are directed for execution to a particular BATS Options Market Maker. For a BATS Options Market Maker to participate in an execution against a Directed Order, (1) the Directed Order must be from a BATS Options Member that is on a list of eligible Options Members provided to the Exchange by the BATS Options Market Maker, in a manner prescribed by the Exchange, (2) the BATS Options Market Maker must be publicly quoting on BATS at the NBB (for sell Directed Orders) or NBO (for buy Directed Orders) with a Market Maker Price Improving Order that contains a non-displayed amount of price improvement over the NBB or NBO at the time the Directed Order arrives to the Exchange, and (3) the Directed Order must be marketable against the non-displayed price of the Market Maker Price Improving Order.

If the above conditions are met, and if there are no other non-displayed orders at prices equal to or better than the non-displayed price of the Market Maker Price Improving Order, the Directed Order will trade with the Market Maker Price Improving Order up to the full displayed size of the Market Maker Price Improving Order. Any

remaining contracts from the Directed Order will be handled, consistent with the instructions on the Directed Order, in accordance with the order display and book processing requirements of Rule 21.8 and, if applicable, processed in accordance with the order routing requirements of Rule 21.9.

If there are non-displayed orders on the BATS Options Book at prices equal to or better than the non-displayed price of the Market Maker Price Improving Order, those other non-displayed orders will in all cases have priority over the non-displayed price of the Market Maker Price Improving Order. In such circumstances, the Market Maker Price Improving Order may still execute at its non-displayed price against the Directed Order consistent with the price/time priority provisions of Rule 21.8 to the extent of any remaining contracts of the Directed Order. Any contracts remaining of the Directed Order will continue to be processed in a manner consistent with the order display and book processing provisions of Rule 21.8, and if applicable, the order routing provisions of Rule 21.9.

As proposed, an Options Market Maker Price Improving Order would be required to have a non-displayed price better than the displayed limit price that could be entered in an increment as small as (1) one cent. The non-displayed price of a Market Maker Price Improving Order is not entered into the BATS Options Book, and is only eligible to trade with a Directed Order to the extent that certain conditions precedent are satisfied, including (1) that the displayed price of the Market Maker Price Improving Order is equal to the NBB (for sell directed orders) or the NBO (for buy directed orders) at the time the Directed Order arrives to the Exchange, and (2) that there are no other orders on the

BATS Options Book at prices equal to or better than the non-displayed prices of the Market Maker Price Improving Order.<sup>4</sup>

As noted elsewhere in this proposal, in *all* cases a Market Maker Price Improving Order must include a displayed price that is equal to the NBB or NBO for such order to be eligible to execute at its non-displayed price against a Directed Order. As such, the proposal enhances the public price discovery process – if the market maker is not publicly quoting at the NBB or NBO at the time the Directed Order arrives to BATS Options, the market maker will only trade with that Directed Order to the extent that any other interest on the BATS Options Book at or better than the NBB or NBO and any other interest with price/time priority over the market maker’s order is first satisfied. Accordingly, in order to enjoy the benefits of trading against Directed Orders, a market maker is required to publicly display a competitively priced order which is available, and hence at risk, to all Options Members

The Exchange is also proposing to delete certain language from its existing Price Improving Order rule text. In particular, as currently written, Rule 21.1(d)(6) states that “Price Improving Orders that are available for display ... .”<sup>5</sup> The Exchange is proposing to delete the clause “that are available to display,” which although intended to simply distinguish an order executed upon arrival to the Exchange from an order posting to the BATS Options Book, has the potential to cause confusion to the extent it may suggest that Price Improving Orders can be posted on the BATS Options Book without a

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<sup>4</sup> As described in proposed Rule 11.9(c)(13)(B), all other interest on the BATS Book at prices equal to or better than the non-displayed price of the Market Maker Price Improving Order has priority over the Market Maker Price Improving Order and, hence, will execute first against the Directed Order.

<sup>5</sup> Emphasis added.

displayed price. That is not the case today, would not be the case under the proposed changes to the rules, and BATS is proposing to delete this clause to eliminate any confusion on this point.

The elements of the Exchange's proposal to create a directed order program are specifically designed to enhance opportunities available in the market for Options Members to obtain price improvement for customer orders in the context of BATS' price/time priority, continuous auction market. By requiring BATS Options Market Makers to be quoting at the NBB or NBO to participate in an execution against a Directed Order directed to it, BATS' proposal incentivizes market makers to competitively quote and thereby furthers the public price discovery process. By further requiring BATS Options Market Makers to include a non-displayed price better than the displayed limit price at an increment as small as (1) one cent, the proposal increases the opportunities for customer orders to receive price improvement over the NBBO. Moreover, by permitting all Options Members to enter orders in the same increments as Market Maker Price Improving Orders, 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.

Further, the proposal provides all market participants, including other market makers that do not have orders directed to them, with the ability to compete with market makers for executions against Directed Orders. BATS notes that all members, including market makers, have the ability to enter Price Improving Orders and any other orders that can compete in the same price increments with a particular market maker's Market

Maker Price Improving Order. In options classes not subject to the penny pilot, market makers and non-market makers have the ability under the proposal to post orders with non-displayed prices at penny increments between the NBBO. Importantly, in all cases, market makers cede priority to all other orders priced equal to or better than the non-displayed price of their Market Maker Price Improving Orders. In options classes subject to the penny pilot, all market participants can effectively compete against non-displayed Market Maker Price Improving Orders simply by improving the NBBO. In BATS' price/time priority market, the non-displayed portion of a Market Maker Price Improving Order will only execute at the non-displayed price when that price is the best available price. In addition, through its fee structure and "maker/taker" pricing, BATS currently incents and intends to continue to provide certain incentives to BATS Options Members to display aggressively priced liquidity on BATS Options.

BATS also wishes to make clear that its proposal has no impact on its existing rules regarding customer order facilitation. Today, BATS members seeking to facilitate customer order on BATS Options must comply with facilitation rules requiring the member to expose either the customer order or the principal order on the exchange for one second prior to a facilitation execution. These rules are similar to rules in effect on other exchanges, and the Exchange's proposal does not amend these requirements.<sup>6</sup>

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<sup>6</sup> Specifically, BATS Rule 22.12 prohibits Options Members from executing "as principal orders they represent as agent unless (a) agency orders are first exposed on BATS Options for at least one (1) second or (b) the Options Member has been bidding or offering on BATS Options for at least one (1) second prior to receiving an agency order that is executable against such bid or offer (exposure)." Rule 22.12 prevents Options Members from executing agency orders to increase economic gain from trading against the order without first giving other trading interest on BATS Options an opportunity to either trade with the agency order or

Pursuant to the proposed directed order program, a BATS Options Member who notifies a BATS Options Market Maker of its intention to submit a Directed Order to BATS Options 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 would be engaging in conduct inconsistent with just and equitable principles of trade in violation of Rule 3.1 and Rule 18.4(f). In addition, 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 Exchange's Rule 22.10, "Limitations on Dealings". BATS will proactively conduct surveillance for such conduct and enforce against such violations.

The Exchange is proposing to adopt Rules 21.1(d)(13) and 21.1(d)(14) as a six month pilot. During this pilot period, the Exchange will study the impact of the rules and will provide the Commission with reports detailing its ongoing review of the pilot. These reports will include: (1) data and analysis regarding price improvement trends following implementation of the directed order program; (2) an assessment of the quotation spreads on BATS Options; (3) data reflecting the size and depth of markets; (4) and descriptions of any patterns that emerge during the pilot period.

(b) Statutory Basis

Approval of the rule changes proposed in this submission on a pilot basis is consistent with the requirements of the Act and the rules and regulations thereunder that

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to trade at the execution price when the Options Member was already bidding or offering on the book.

are applicable to a national securities exchange, and, in particular, with the requirements of Section 6(b) of the Act.<sup>7</sup> In particular, the proposed change is consistent with Section 6(b)(5) of the Act,<sup>8</sup> because it would promote just and equitable principles of trade, remove impediments to, and perfect the mechanism of, a free and open market and a national market system, and, in general, protect investors and the public interest.

The Exchange believes that the proposed rule meets these requirements in that it promotes competition for customer orders and furthers the public price discovery process by both incentivizing BATS Options Market Makers to publicly display aggressive quotes at the NBBO, as well as incentivizing BATS Options Market Makers and all other BATS Options Members to post non-displayed prices better than the NBBO. BATS notes that the Commission has previously found consistent with the Act non-displayed order types designed to provide price improvement at prices smaller than the minimum price variation in listed options.<sup>9</sup>

Moreover, the Commission has previously approved rules that provide specialist or market maker guarantees up to a certain percentage so long as the specialist or market maker is quoting at the NBBO and such guarantees do not rise to a level that could have a material adverse impact on quote competition with a particular exchange.<sup>10</sup> While BATS' directed order program requires BATS Options Market Makers to be quoting at

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<sup>7</sup> 15 U.S.C. 78f(b).

<sup>8</sup> 15 U.S.C. 78f(b)(5).

<sup>9</sup> See, e.g., BATS Options Rule 21.1(d)(6) "Price Improving Orders" ; Nasdaq Options Market Rule Chapter VI, Section 1(e)(6) "Price Improving Orders".

<sup>10</sup> See, e.g., Securities Exchange Act Release No. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (SR-Phlx-2004-91) (order approving the establishment of a directed order process with certain specialist participation guarantees).

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.

In addition, 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 explicitly approved a process similar to that proposed by BATS in the equity markets in which only those members who have been permissioned by a market maker are eligible to submit directed orders to the market maker.<sup>11</sup> And, the Commission has implicitly approved such processes in the options markets 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 options member into a brief price improvement auction in which all members have the ability to compete for the execution.<sup>12</sup> BATS' proposed rule

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<sup>11</sup> See Securities Exchange Act Release No. 52827 (November 23, 2005), 70 FR 72193 (December 1, 2005) (SR-PCX-2005-56) (order approving certain modifications to the PCX Equities, Inc.'s Directed Order Process on the Archipelago Exchange).

<sup>12</sup> See, e.g., BOX Rule Section 18 "The Price Improvement Period" and ISE Rule 723 "Price Improvement Mechanism for Crossing Transactions" (both of which providing a mechanism for options members that want to internalize customer orders the ability to do so on the exchanges subject to a requirement that such orders first be exposed to all other options members through a brief price improvement auction).

changes are similar in nature to these price improvement auctions, except that under BATS' proposal, competition for the execution with a Directed Order occurs in the context of BATS' continuous, price/time priority auction, rather than during a separate, one-second price improvement auction. As such, concerns about customer orders potentially "missing the market" during that exposure period are not present. That said, however, BATS has proposed to the Commission price improvement data and other data deemed necessary to evaluate the impact of the proposal. Also, as previously mentioned, BATS' proposal differs from existing price improvement auctions due to the fact that BATS Options Market Makers would have no participation guarantees.

The Exchange notes market makers already retain the discretion to pay certain firms non-transparent payment for order flow amounts. The 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.

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

The proposed rule change does not impose any burden on competition.

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

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any written comments from members or other interested parties.

6. Extension of Time Period for Commission Action

Not applicable.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rule of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

Exhibit 1: Completed Notice of the Proposed Rule Change for publication in the Federal Register.

Exhibit 2 – 5: Not applicable.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-\_\_\_\_\_ ; File No. SR-BATS-2011-009)

Self-Regulatory Organizations; BATS Exchange, Inc.; Notice of Proposed Rule Change to Create a Directed Order Program.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on March 16, 2011, BATS Exchange, Inc. (the “Exchange” or “BATS”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange is filing with the Commission a proposal for the BATS Exchange Options Market (“BATS Options”) to create, on a pilot basis, new BATS Rule 21.1(d)(13), entitled “Market Maker Price Improving Orders” and new BATS Rule 21.1(d)(14), entitled “Directed Orders.” The Exchange also proposes to amend existing BATS Rule 21.1(d)(2), entitled “Price Improving Orders.”

The text of the proposed rule change is available at the Exchange’s Web site at <http://www.batstrading.com>, at the principal office of the Exchange, and at the Commission’s Public Reference Room.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant parts of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange is proposing certain modifications and additions to its rules related to the trading of options. First, the Exchange is proposing the establishment of new Rule 21.1(d)(13), entitled Market Maker Price Improving Orders. Second the Exchange is proposing the establishment of new Rule 21.1(d)(14), entitled Directed Orders. Third, the Exchange is proposing to modify the text of Rule 21.1(d)(6), entitled Price Improving Orders, to make a clarifying change.<sup>3</sup>

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<sup>3</sup> The Exchange previously filed a proposal to establish a directed order program for BATS Options. See Securities Exchange Act Release No. 63403 (December 1, 2010), 75 FR 76059 (December 7, 2010) (SR-BATS-2010-034) (notice of filing of directed order program proposal). The Exchange withdrew its original filing in its entirety and has re-filed this proposal to address comments received on the proposal by eliminating the originally proposed midpoint order functionality, to provide additional clarity in a few areas, and to propose operation of the directed order program on a pilot basis. In a manner consistent with this filing, the Exchange also responded to comments received on the original proposal. See Letter from Eric J. Swanson, Secretary, BATS Exchange, Inc. to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission dated February 24, 2011.

The Exchange is proposing the rule changes described below to establish a directed order program through which members of BATS Options (“Options Members”) can direct an order to a particular BATS Options Market Maker for potential execution at a price improved over the existing National Best Bid (“NBB”) or National Best Offer (“NBO”). As part of this program, BATS is proposing to define two new order types. The first would be new Rule 21.1(d)(13), entitled Market Maker Price Improving Orders, which are orders from a BATS Options Market Maker to buy or sell an option that has a displayed price and size and a non-displayed price at which the BATS Options Market Maker is willing to trade with a Directed Order. As proposed, a Market Maker Price Improving Order would be ranked on the BATS Options Book at its displayed price. The non-displayed price of the Market Maker Price Improving Order would not be entered into the BATS Options Book, but would be, along with its displayed size, converted to a buy or sell order at its non-displayed price in response to a Directed Order directed to the BATS Options Market Maker. For the avoidance of doubt, the Exchange reiterates that, as proposed, the full displayed size of a Market Maker Price Improving Order, and only the full *displayed size* of a Market Maker Price Improving Order, is available to trade with a Directed Order directed to a BATS Options Market Maker. Key to the structure of the proposal is that it creates incentives for *displayed* price and size discovery available to all market participants.

The second new order type proposed would be new Rule 21.1(d)(14), entitled Directed Orders, which are orders from a BATS Options Member that are directed for execution to a particular BATS Options Market Maker. For a BATS Options Market Maker to participate in an execution against a Directed Order, (1) the Directed Order

must be from a BATS Options Member that is on a list of eligible Options Members provided to the Exchange by the BATS Options Market Maker, in a manner prescribed by the Exchange, (2) the BATS Options Market Maker must be publicly quoting on BATS at the NBB (for sell Directed Orders) or NBO (for buy Directed Orders) with a Market Maker Price Improving Order that contains a non-displayed amount of price improvement over the NBB or NBO at the time the Directed Order arrives to the Exchange, and (3) the Directed Order must be marketable against the non-displayed price of the Market Maker Price Improving Order.

If the above conditions are met, and if there are no other non-displayed orders at prices equal to or better than the non-displayed price of the Market Maker Price Improving Order, the Directed Order will trade with the Market Maker Price Improving Order up to the full displayed size of the Market Maker Price Improving Order. Any remaining contracts from the Directed Order will be handled, consistent with the instructions on the Directed Order, in accordance with the order display and book processing requirements of Rule 21.8 and, if applicable, processed in accordance with the order routing requirements of Rule 21.9.

If there are non-displayed orders on the BATS Options Book at prices equal to or better than the non-displayed price of the Market Maker Price Improving Order, those other non-displayed orders will in all cases have priority over the non-displayed price of the Market Maker Price Improving Order. In such circumstances, the Market Maker Price Improving Order may still execute at its non-displayed price against the Directed Order consistent with the price/time priority provisions of Rule 21.8 to the extent of any remaining contracts of the Directed Order. Any contracts remaining of the Directed

Order will continue to be processed in a manner consistent with the order display and book processing provisions of Rule 21.8, and if applicable, the order routing provisions of Rule 21.9.

As proposed, an Options Market Maker Price Improving Order would be required to have a non-displayed price better than the displayed limit price that could be entered in an increment as small as (1) one cent. The non-displayed price of a Market Maker Price Improving Order is not entered into the BATS Options Book, and is only eligible to trade with a Directed Order to the extent that certain conditions precedent are satisfied, including (1) that the displayed price of the Market Maker Price Improving Order is equal to the NBB (for sell directed orders) or the NBO (for buy directed orders) at the time the Directed Order arrives to the Exchange, and (2) that there are no other orders on the BATS Options Book at prices equal to or better than the non-displayed prices of the Market Maker Price Improving Order.<sup>4</sup>

As noted elsewhere in this proposal, in *all* cases a Market Maker Price Improving Order must include a displayed price that is equal to the NBB or NBO for such order to be eligible to execute at its non-displayed price against a Directed Order. As such, the proposal enhances the public price discovery process – if the market maker is not publicly quoting at the NBB or NBO at the time the Directed Order arrives to BATS Options, the market maker will only trade with that Directed Order to the extent that any other interest on the BATS Options Book at or better than the NBB or NBO and any

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<sup>4</sup> As described in proposed Rule 11.9(c)(13)(B), all other interest on the BATS Book at prices equal to or better than the non-displayed price of the Market Maker Price Improving Order has priority over the Market Maker Price Improving Order and, hence, will execute first against the Directed Order.

other interest with price/time priority over the market maker's order is first satisfied.

Accordingly, in order to enjoy the benefits of trading against Directed Orders, a market maker is required to publicly display a competitively priced order which is available, and hence at risk, to all Options Members

The Exchange is also proposing to delete certain language from its existing Price Improving Order rule text. In particular, as currently written, Rule 21.1(d)(6) states that "Price Improving Orders that are available for display ... ." <sup>5</sup> The Exchange is proposing to delete the clause "that are available to display," which although intended to simply distinguish an order executed upon arrival to the Exchange from an order posting to the BATS Options Book, has the potential to cause confusion to the extent it may suggest that Price Improving Orders can be posted on the BATS Options Book without a displayed price. That is not the case today, would not be the case under the proposed changes to the rules, and BATS is proposing to delete this clause to eliminate any confusion on this point.

The elements of the Exchange's proposal to create a directed order program are specifically designed to enhance opportunities available in the market for Options Members to obtain price improvement for customer orders in the context of BATS' price/time priority, continuous auction market. By requiring BATS Options Market Makers to be quoting at the NBB or NBO to participate in an execution against a Directed Order directed to it, BATS' proposal incentivizes market makers to competitively quote and thereby furthers the public price discovery process. By further requiring BATS Options Market Makers to include a non-displayed price better than the

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<sup>5</sup> Emphasis added.

displayed limit price at an increment as small as (1) one cent, the proposal increases the opportunities for customer orders to receive price improvement over the NBBO.

Moreover, by permitting all Options Members to enter orders in the same increments as Market Maker Price Improving Orders, 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.

Further, the proposal provides all market participants, including other market makers that do not have orders directed to them, with the ability to compete with market makers for executions against Directed Orders. BATS notes that all members, including market makers, have the ability to enter Price Improving Orders and any other orders that can compete in the same price increments with a particular market maker's Market Maker Price Improving Order. In options classes not subject to the penny pilot, market makers and non-market makers have the ability under the proposal to post orders with non-displayed prices at penny increments between the NBBO. Importantly, in all cases, market makers cede priority to all other orders priced equal to or better than the non-displayed price of their Market Maker Price Improving Orders. In options classes subject to the penny pilot, all market participants can effectively compete against non-displayed Market Maker Price Improving Orders simply by improving the NBBO. In BATS' price/time priority market, the non-displayed portion of a Market Maker Price Improving Order will only execute at the non-displayed price when that price is the best available price. In addition, through its fee structure and "maker/taker" pricing, BATS currently

incentives and intends to continue to provide certain incentives to BATS Options Members to display aggressively priced liquidity on BATS Options.

BATS also wishes to make clear that its proposal has no impact on its existing rules regarding customer order facilitation. Today, BATS members seeking to facilitate customer order on BATS Options must comply with facilitation rules requiring the member to expose either the customer order or the principal order on the exchange for one second prior to a facilitation execution. These rules are similar to rules in effect on other exchanges, and the Exchange's proposal does not amend these requirements.<sup>6</sup>

Pursuant to the proposed directed order program, a BATS Options Member who notifies a BATS Options Market Maker of its intention to submit a Directed Order to BATS Options 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 would be engaging in conduct inconsistent with just and equitable principles of trade in violation of Rule 3.1 and Rule 18.4(f). In addition, 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

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<sup>6</sup> Specifically, BATS Rule 22.12 prohibits Options Members from executing "as principal orders they represent as agent unless (a) agency orders are first exposed on BATS Options for at least one (1) second or (b) the Options Member has been bidding or offering on BATS Options for at least one (1) second prior to receiving an agency order that is executable against such bid or offer (exposure)." Rule 22.12 prevents Options Members from executing agency orders to increase economic gain from trading against the order without first giving other trading interest on BATS Options an opportunity to either trade with the agency order or to trade at the execution price when the Options Member was already bidding or offering on the book.

Exchange's Rule 22.10, "Limitations on Dealings". BATS will proactively conduct surveillance for such conduct and enforce against such violations.

The Exchange is proposing to adopt Rules 21.1(d)(13) and 21.1(d)(14) as a six month pilot. During this pilot period, the Exchange will study the impact of the rules and will provide the Commission with reports detailing its ongoing review of the pilot. These reports will include: (1) data and analysis regarding price improvement trends following implementation of the directed order program; (2) an assessment of the quotation spreads on BATS Options; (3) data reflecting the size and depth of markets; (4) and descriptions of any patterns that emerge during the pilot period.

## 2. Statutory Basis

Approval of the rule changes proposed in this submission on a pilot basis is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange, and, in particular, with the requirements of Section 6(b) of the Act.<sup>7</sup> In particular, the proposed change is consistent with Section 6(b)(5) of the Act,<sup>8</sup> because it would promote just and equitable principles of trade, remove impediments to, and perfect the mechanism of, a free and open market and a national market system, and, in general, protect investors and the public interest.

The Exchange believes that the proposed rule meets these requirements in that it promotes competition for customer orders and furthers the public price discovery process by both incentivizing BATS Options Market Makers to publicly display aggressive quotes at the NBBO, as well as incentivizing BATS Options Market Makers and all other

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<sup>7</sup> 15 U.S.C. 78f(b).

<sup>8</sup> 15 U.S.C. 78f(b)(5).

BATS Options Members to post non-displayed prices better than the NBBO. BATS notes that the Commission has previously found consistent with the Act non-displayed order types designed to provide price improvement at prices smaller than the minimum price variation in listed options.<sup>9</sup>

Moreover, the Commission has previously approved rules that provide specialist or market maker guarantees up to a certain percentage so long as the specialist or market maker is quoting at the NBBO and such guarantees do not rise to a level that could have a material adverse impact on quote competition with a particular exchange.<sup>10</sup> While 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.

In addition, the Commission has previously approved rules that permit a specialist or market maker to determine the firms from which it will accept directed or preferred orders. The Commission has explicitly approved a process similar to that proposed by BATS in the equity markets in which only those members who have been permissioned

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<sup>9</sup> See, e.g., BATS Options Rule 21.1(d)(6) "Price Improving Orders" ; Nasdaq Options Market Rule Chapter VI, Section 1(e)(6) "Price Improving Orders".

<sup>10</sup> See, e.g., Securities Exchange Act Release No. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (SR-Phlx-2004-91) (order approving the establishment of a directed order process with certain specialist participation guarantees).

by a market maker are eligible to submit directed orders to the market maker.<sup>11</sup> And, the Commission has implicitly approved such processes in the options markets 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 options member into a brief price improvement auction in which all members have the ability to compete for the execution.<sup>12</sup> BATS' proposed rule changes are similar in nature to these price improvement auctions, except that under BATS' proposal, competition for the execution with a Directed Order occurs in the context of BATS' continuous, price/time priority auction, rather than during a separate, one-second price improvement auction. As such, concerns about customer orders potentially "missing the market" during that exposure period are not present. That said, however, BATS has proposed to the Commission price improvement data and other data deemed necessary to evaluate the impact of the proposal. Also, as previously mentioned, BATS' proposal differs from existing price improvement auctions due to the fact that BATS Options Market Makers would have no participation guarantees.

The Exchange notes market makers already retain the discretion to pay certain firms non-transparent payment for order flow amounts. The proposal similarly retains

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<sup>11</sup> See Securities Exchange Act Release No. 52827 (November 23, 2005), 70 FR 72193 (December 1, 2005) (SR-PCX-2005-56) (order approving certain modifications to the PCX Equities, Inc.'s Directed Order Process on the Archipelago Exchange).

<sup>12</sup> See, e.g., BOX Rule Section 18 "The Price Improvement Period" and ISE Rule 723 "Price Improvement Mechanism for Crossing Transactions" (both of which providing a mechanism for options members that want to internalize customer orders the ability to do so on the exchanges subject to a requirement that such orders first be exposed to all other options members through a brief price improvement auction).

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.

(B) Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change imposes any burden on competition.

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

The Exchange has neither solicited nor received written comments on the proposed rule change.

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will: (a) by order approve such proposed rule change, or (b) institute proceedings to determine whether the proposed rule change should be disapproved..

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposal 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](mailto:rule-comments@sec.gov). Please include File No. 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 No. 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 changes 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 10:00 am and 3:00 pm. Copies of such filing will also 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 No. SR-BATS-2011-009 and should be submitted on or before [\_\_\_\_\_21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to  
delegated authority.<sup>13</sup>

Cathy H. Ahn  
Deputy Secretary

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<sup>13</sup> 17 CFR 200.30-3(a)(12).