



November 20, 2009

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

**RE: Elimination of Flash Order Exception from Rule 602 of Regulation NMS No. 34-60684; File No. S7-21-09**

Ms. Murphy:

BATS Exchange, Inc. (“BATS”) appreciates the opportunity to comment on the above referenced proposal (“Proposal”) to eliminate the “flash” order exception from Rule 602 of Regulation NMS (“Rule 602”). In addition to amending Rule 602, the Commission is proposing to apply an interpretation to Rule 301(b) of Regulation ATS consistent with the proposed amendments to Rule 602. Pursuant to Rule 602, exchanges are generally required to make their best bids and offers available in the consolidated quotation data disseminated to the public. Rule 602, however, contains an exception for bids and offers communicated on an exchange that are either immediately executed, cancelled, or withdrawn after communication. According to the Commission, this exception was intended to facilitate manual trading in the crowd on exchange floors by excluding quotations that were considered “ephemeral” and impractical to include in the consolidated quotation data.

The Proposal would eliminate this exception from Rule 602, and thus, would ban flash order types in both equities and options markets.<sup>1</sup> The ban would extend beyond the exchanges and would include alternative trading systems.<sup>2</sup> In doing so, the Commission is recognizing that securities trading has automated to the extent that “ephemeral” flash quotations offer as much trading information value as quotations that are disseminated in the consolidated quotation data. Accordingly, and for various policy reasons discussed below, the Commission preliminary believes the “immediate execution or withdrawal” exception from Rule 602 no longer serves the

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<sup>1</sup> In the options markets, processes identical to flash order functionality are generally referred to as “step-up” auctions.

<sup>2</sup> Pursuant to Rule 301 under Regulation ATS, an ATS that displays subscriber orders to any person and meets a 5% average daily volume threshold must include its best-priced displayed orders in the consolidated quotation data. Consistent with the explicit “immediate execution or withdrawal” exception to the same exchange requirement in Rule 602, the Commission has until now permitted ATSs to utilize flash order functionality. Under the Proposal, in eliminating the exception from Rule 602, the Commission would similarly interpret Rule 301 under Regulation ATS as forbidding flash order functionality for those ATSs that meet the above requirements.

interests of long-term investors and may detract from the efficiency of the national market system.

BATS supports the Commission's Proposal, and applauds the Commission for taking up this issue, and for proposing the elimination of flash order types on rational policy grounds rather than on the exaggerated and often irrational concerns voiced widely in the media over the last several months. BATS briefly offered a version of the "flash" order (referred to as "BOLT") earlier this year. When we implemented BOLT, we publicly stated that we did so for competitive reasons, but that we were concerned about the market structure implications of allowing equities and options exchanges as well as alternative trading systems to continue to offer such order types. In particular, BATS expressed the following concerns:<sup>3</sup>

*Issue 1: Public market venues circulating quotes to an exclusive and private network of users.*

There is a possibility of creating a "two-tiered" market, where the best quotations from specific markets are made available to a limited number of market participants.

*Issue 2: "Price forming" resting orders at other markets being traded around.*

Customers who display orders in a public market are helping to establish reference prices and are a vital part of an efficient price discovery process. Under Reg NMS, the orders that form a market's Protected Quote are protected from being traded through. However, these orders are not protected against another market trading at the same price. While trade through protection would continue to exist with the existence of BOLT/Flash/ELP, these processes create a greater frequency of instances in which Protected Quotes are denied an execution they would have otherwise received. The risk of being "traded at" creates a disincentive to post aggressive limit orders and thereby harms the price discovery process.

*Issue 3: Locked markets in a regulatory structure designed to avoid them.*

In the current Reg NMS environment, both the spirit and the letter of the law speak to the avoidance of locked markets. BOLT/Flash/ELP as well as step-up auctions create locked markets. During the period in which marketable orders are being exposed to a private network of users, those same orders are effectively priced at a locking price.

*Issue 4: Disconnected consolidated tape stream that doesn't reflect the markets' best prices.*

The consolidated tape has long been the industry reference for the market's top of book quotes. It can be used as a benchmark for best execution, and it can be used as a basis for determining the NBBO (National Best Bid and Best Offer). In

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<sup>3</sup>

<http://www.batstrading.com/resources/newsletters/2009-07-Newsletter.pdf>.

BOLT, Flash, and ELP, “exposed orders” are not reflected in the consolidated tape, which might create a potentially harmful disconnect in the public quote stream over time.

*Issue 5: Confusion between accessing Protected Quotes versus achieving best execution.*

The general obligation to seek access to “reasonably available” prices that are better than the NBBO is a well established tenet of the best execution obligation. BOLT, Flash, and ELP raise questions about whether the better quotations temporarily shown to a private network of users are truly “reasonably available” to many brokers handling agency orders. To be compliant with their best execution obligations, are all such brokers required to go to the expense of taking in direct feeds and seeking access to these fleeting better-priced quotations? Or, in doing so are they running the risk that not only will they fail to access the better priced quotations but will also miss the published markets for their customers? While each firm’s experience will guide it, it seems that this issue is one which may cause confusion and conflict.

*Issue 6: Increased requirement to take and digest all direct feeds.*

As the previous issues are being considered, a common central theme also emerges. In order to resolve these issues, brokers may discover that they have a new requirement to take and digest all available direct feeds. Without taking each individual direct feed, a broker may not be aware of all the best priced orders in the market.

As a result of these concerns, BATS advocated for an industry-wide voluntary withdrawal of these order types pending review by the Commission. BATS and NASDAQ OMX ceased to offer this functionality at the end of August. Review by the Commission has resulted in the current Proposal to ban this functionality in both the equities and options markets based on many of the factors BATS enumerated above. BATS believes this is the right result.

BATS agrees with the Commission’s preliminary assessment that any benefits that may flow from flash functionality do not justify their negative aspects as outlined above. BATS is particularly concerned that flash order functionality creates disincentives for market participants to display aggressive quotations in the public markets because of the greater likelihood that a displayed order will not be rewarded with an execution. Instead, contra-side interest sent to another displayed market could be executed against undisplayed liquidity held by a market participant receiving the flash quote data feed.

In expressing our concerns, BATS is mindful of the potential implications of its position relative to internalization and dark pools generally, including additional non-flash competitive offerings by BATS and other public markets that integrate public markets with such pools of non-displayed liquidity and which can similarly create disincentives to publicly display limit orders. In fact, some have suggested that if a ban on flash order functionality is taken to its

logical conclusion, the Commission would be required to ban all forms of internalization and require all trading interests to be publicly displayed. BATS strongly disagrees with such hyperbolic rhetoric. Rule making by its very nature often requires a delicate balance between seemingly competing policy goals. In the instant case, the Commission is in part seeking to strike a balance between fostering inter-market competition and fostering the price discovery process by encouraging the public display of limit orders.

BATS also believes there are no rational policy distinctions upon which to distinguish the appropriateness of flash order functionality between the equities and options markets. Both markets today are highly automated; both contain significant retail investor participation. The options markets have adopted market structure rules comparable to the Regulation NMS trade through and locked and crossed prohibitions, and the flash functionality in the options markets involves the display of better prices to a select group of traders. As such, the policy concerns associated with creating a two-tiered market, discouraging the public display of limit orders, and creating locked markets are all present in the options markets to the same extent as the equities markets.

BATS notes that some market participants believe that step-up functionality should be retained in the options markets, despite a proposed ban in equities. One commenter in particular states that that banning Flash in the options markets would have a detrimental effect on market structure because it would reward one particular market model at the expense of certain participants.<sup>4</sup> This commenter states that the proposed ban of step-ups in options:

- Rewards maker taker exchanges
- Rewards market taker market makers
- Penalizes ‘classic fee’ exchanges
- Penalizes retail brokerage firms
- This will negatively affect retail customers

BATS wholeheartedly disagrees with the conclusion that banning step-up auctions would negatively affect retail customers. Rather, BATS believes that banning flash in the options markets would reward markets that are transparent about their fees, as well as reward market participants who contribute to price discovery. As a result, retail investors would be rewarded with better execution prices and overall lower cost.

We are unconcerned about the potential detrimental impact on a market model that has proliferated in part because of entrenched and opaque payment for order flow arrangements (PFOF). Even markets which today are intimately engrained in these relationships have noted concerns about PFOF. The Chicago Board Options Exchange has stated, “PFOF poses unacceptable harms to the options markets and to investors. PFOF creates conflicts of interest

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<sup>4</sup> See <http://www.sec.gov/comments/s7-21-09/s72109-51.pdf> (“The illusion of maker taker markets”).

between broker-dealers and their customers.”<sup>5</sup> Further, the Commission has noted previously that little of the economic benefit of PFOF is passed on to customers.<sup>6</sup> If, as a result of banning step-up auctions, the “classic” exchanges increasingly compete by posting tighter markets and because of that, the prevalence of opaque payment for order flow is lessened; we would view this as a positive development for the market place.

To reiterate, beyond the beneficial impact of increasing transparency and reducing payment for order flow related to banning step-up auctions, all of the policy concerns present with respect to flash functionality in the equities markets are equally if not more present in the options markets. Accordingly, BATS would not support a result of the Commission’s present rule-making that permitted flash order functionality in the options markets while banning it in the equities markets.

In the Proposal, the Commission specifically requested comment on the extent to which “manual” flashing of orders in a trading floor environment should continue to exist even if “electronic” flashing of orders is prohibited. In requesting this comment, the Commission noted that in some markets floor brokers audibly “request a market” in a security and that the audible response from the trading crowd could be different from the published quotation. BATS sees no reason to create such a distinction. Although trading crowds still exist, all of the securities markets have automated to such an extent that crowd participants now utilize advanced technology to assist with their trading. Tools at the disposal of floor participants include preprogrammed algorithms that have the ability to stream and layer quotes to exchange systems, advanced routing systems for accessing away markets, and sophisticated risk and inventory management systems. As such, it is difficult to understand how rule making could distinguish processes that occur on floor markets from those that occur in markets without trading floors, and even more difficult to see how enforceable guidelines could be created even if a rational distinction could be made. Accordingly, BATS believes the Commission’s ban on flash quote functionality should not attempt to draw a distinction between “manual” floor-based processes and automated processes.

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BATS understands the Commission to be conducting a broad review of the current market structure beyond the instant Proposal to ban flash orders. BATS looks forward to working with the Commission on these initiatives, including its recent proposal related to dark pools, and any forthcoming additional relevant rule-making or concept releases. To that end, BATS believes that in conducting this broad review of market structure, the Commission should be looking closely at practices that result in unfair advantages and, hence, create potential damage to public confidence in the securities markets. BATS also believes that the short term professional traders who make substantial investments in infrastructure will always have an advantage in the active trading of securities, and that mere fact does not give them an “unfair”

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<sup>5</sup> See <http://www.cboe.org/publish/ComLet/20030210.pdf>

<sup>6</sup> See <http://www.sec.gov/news/studies/ordpay.htm>

Elizabeth M. Murphy  
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Page 6 of 6

advantage. Regulators must be vigilant in identifying instances in which such advantage is put to a manipulative purpose; however, as the Commission stated in its Proposal:

Professional short-term traders inevitably have advantages in the active trading of securities – that is, buying and selling securities repeatedly throughout the trading day. Active trading is a highly competitive endeavor, and many professional short-term traders devote substantial resources to develop the systems and expertise to trade successfully. Ultimately, this competition among professional short-term traders can greatly benefit long-term investors if it leads to better execution quality (such as narrower spreads and greater liquidity) when investors enter the market to establish or liquidate their positions in a security.<sup>7</sup>

BATS appreciates the opportunity to comment on the Commission's Proposal. Please feel free to contact me if you have any questions in connection with matter.

Sincerely,



SVP & General Counsel

cc: The Hon. Mary L. Schapiro, Chairman  
The Hon. Kathleen L. Casey, Commissioner  
The Hon. Elisse B. Walter, Commissioner  
The Hon. Luis A. Aguilar, Commissioner  
The Hon. Troy A. Paredes, Commissioner  
Robert W. Cook, Director, Division of Trading and Markets  
James Brigagliano, Division of Trading and Markets  
Daniel M. Gallagher, Division of Trading and Markets

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<sup>7</sup> Proposal at pp. 24-25.