



William J. Brodsky
Chairman and
Chief Executive Officer

Phone: 312-786-7001
Fax: 312-786-7407
brodsky@cboe.com

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Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549-6628

Re: Proposed Amendments to Rule 610 of Regulation NMS, File No. S7-09-10

Dear Ms. Murphy:

The Chicago Board Options Exchange, Incorporated (“CBOE”) respectfully submits these comments on the Commission’s proposed amendments to Rule 610 under the Securities Exchange Act of 1934 (the “Act”). The amendments would (1) establish a limit on the fees that an options exchange can charge to access the displayed best bid and offer for options listed on the exchange, and (2) prohibit an exchange from imposing “unfairly discriminatory” terms on non-members to access quotations. Proposed Amendments to Rule 610 of Regulation NMS, Release No. 34-61902, 75 Fed. Reg. 20738 (Apr. 14, 2010) (“Proposing Release”).

CBOE is the largest U.S. options exchange and the leading creator of listed options products. As recognized in the Commission’s Proposing Release, CBOE may also be the entity most seriously affected by the Commission’s proposal to cap options exchange fees. CBOE supports the Commission’s efforts to improve the national market system and ensure fairness and

transparency for investors, but respectfully disagrees with the approach in the current fee cap proposal.

Introduction

With its proposed amendment to Section 610(c), the Commission would limit to \$0.30 per contract the amount that options exchanges can charge in fees for execution of orders that access displayed quotations. There currently is no such regulatory limit on the “access” or “transaction” fees that may be charged by options exchanges, although all exchange fees are required to be filed with the Commission, which has the authority to abrogate them. More importantly, and as discussed below, exchange fees are constrained by what the Commission itself recognizes to be robust competition among the options exchanges.

The Proposing Release offers several, interrelated rationales for imposing these proposed price controls. In an effort to foster a “national market system” (“NMS”) for securities, the Commission has imposed “intermarket” “linkage” requirements on securities exchanges which provide, among other things, that an exchange must “match the best quoted prices, cancel orders without an execution, or route orders to the trading centers quoting the best prices.” Final Rule, Regulation NMS, Release No. 34-51808, 70 Fed. Reg. 37496, 37525 (Jun. 29, 2005). Options exchanges have, at the Commission’s directive, adopted a similar “linkage” plan. Subject to limited exceptions, exchanges are thereby prohibited from “trading through” a better priced quotation displayed on another options exchange, although currently exchanges may give participants on that exchange an opportunity to “step up” to the “National Best Bid and Offer” (“NBBO”) before the order is routed to another exchange. (This so-called “flash” functionality is the subject of a separate Commission rulemaking.)

Transaction fees that are imposed on the executions of trades are the most important source of revenue for options exchanges, as discussed further below. The amount of these fees and the circumstances in which they are imposed vary among exchanges, although the fees are publicly-known and available, are programmed into the order routing and execution management systems that route orders for execution to the various exchanges, and are always less than the penny increment that is the minimum difference in price for most options. It is this variation in transaction fee prices—something ordinarily considered a necessary and beneficial aspect of a

competitive market—which underlies the proposed fee cap. The Proposing Release states that because access fees vary and are an added cost of a trade, the “all-in price for the trade” cannot “readily” be ascertained from the displayed quote. Proposing Release, 75 Fed. Reg. at 20755. Price controls for access fees would cause exchanges’ quoted prices to “more closely reflect the total cost of a trade,” making quotation information “more useful” and the cost of accessing quoted prices “more transparent.” *Id.* The Release suggests that the rule would also “prohibit individual exchanges from raising their fees substantially in an attempt to take improper advantage of protection against trade throughs” with “exorbitant fees.” *Id.* at 20743. Under the existing system, orders already may be routed to the exchange that displays the NBBO with the lowest transaction fees, which the Release recognizes to be a “significant incentive[]” to avoid high fees. *Id.* But, the Release suggests, some exchanges might charge high fees knowing that they “would be the last exchange to which orders would be routed, [but that] prices could not move to the next level until someone routed an order to take out the displayed price at such a high fee exchange.” *Id.* Generally, the Release suggests, “the integrity of the price protection requirement under the Trade-Through Rules” (*id.*) would be furthered if a person submitting an order to one exchange were not subjected to a transaction fee at another exchange that is significantly different than the fee chargeable at the exchange initially receiving the order.

The principal reason for the specific amount of the proposed cap—\$0.30 per options contract—appears to be that this was the amount of the cap imposed on equities in an earlier rulemaking. *See id.* at 20745.

In the comments that follow, CBOE respectfully submits that the proposed fee cap is unnecessary and unwarranted and would have significant adverse consequences for options exchanges and market participants.

1. The imposition of federal price controls is always a drastic measure, and CBOE respectfully submits that there is no need or justification for taking such a step with respect to options exchanges. The options markets are competitive by the Commission’s own admission, and in the past the Commission has recognized that vibrant competition is a powerful reason to abstain from regulatory price intervention. Moreover, to the extent that rare circumstances arise that warrant direct price regulation by the Commission, the agency already has that opportunity

in the statutory requirement that options exchanges' fees be filed with the Commission and subject to abrogation by the agency within 60 days. The same is not true for all stock execution fees, since many stock trades occur on venues that are not registered with the Commission as securities exchanges.

2. The particular cap proposed by the Commission would extend far more broadly than the rationale offered to support it. The rationale given for the cap is to prevent some options exchanges from charging transaction fees for accessing exchanges' displayed quotations that are significantly higher than other exchanges'. When such variations in price occur, the Proposing Release suggests, the transparency and comparability of quotes in the NMS are impaired, and higher-priced exchanges might take advantage of the intermarket requirement that orders be routed to them when they offer the NBBO. These purported problems could only arise when an order is routed for execution on an exchange other than the exchange where the order was first placed. Yet, the proposed rule applies regardless of where the order was placed, and even applies to options that are only listed on a single options exchange. Similarly, the proposed rule would seemingly apply to a range of transactions, including FLEX option trades and complex order executions, that are not made against NMS displayed quotes.

3. The specific point at which the Commission has set the fee cap—\$0.30 per contract—is insupportable. When the Commission adopted Regulation NMS, it made clear that it was adopting a fee that approximated the highest fees then being charged by trading centers for executions in the cash market. By contrast, the Proposing Release readily acknowledges that numerous options exchanges currently charge fees well in excess of \$0.30. This change in approach by the Commission has not been explained, is improper, and would have serious adverse consequences because options exchanges, unlike stock exchanges, do not earn listing fees or substantial market data fees, have less ability to charge significant membership fees, and rely more heavily on transaction fees to recoup costs. In short, in a market where transaction fees are a far more important source of revenue and commercial vitality, the Commission inexplicably has abandoned an approach under which it set a cap at approximate current market rates, pursuing instead an aggressive, fee-cutting strategy.

For all of these reasons, and as explained below, CBOE respectfully submits that the Commission should not impose a cap of any kind on options exchange fees. Were the Commission to proceed with the cap contained in the proposal, it would sharply reduce the revenues available to CBOE and other options exchanges. That would undermine the exchanges' ability and incentive to innovate and introduce new products, which in turn would deter the introduction of popular new financial products and impede capital formation. There would be an adverse effect on competition with other markets that are not as heavily regulated or subject to a fee cap, such as futures markets (another derivatives-based market whose product can be used to hedge against risks on particular positions or strategies), the over-the-counter ("OTC") market, and overseas options markets. Finally, a substantial question about the Commission's authority to impose across-the-board price controls would be presented.¹

I. Background: CBOE And Its Interest In This Rulemaking.

CBOE is the largest U.S. options exchange and the national leader in options product innovation. Unlike stock exchanges, CBOE does not generate substantial revenue from listing fees or market data fees. Rather, its operating revenues derive primarily from the number of contracts traded on the exchange and the amount it charges for those contracts. These "transaction fees" accounted for 73.8% of the exchange's total operating revenues in 2009.²

¹ With respect to the Commission's proposed "anti-discrimination" provision, CBOE has no objection to it as stated, but respectfully requests that the Commission make clear that it will not be interpreted to prohibit volume discounts or preferred pricing, applied objectively, for certain types of customers (such as large retail brokerage firms). As evidenced by the exchange's move to a "for-profit" model, exchanges are not utilities and should be free to establish preferred pricing to certain classes of customers if they desire. CBOE believes that any restrictions on preferred pricing would also have an adverse economic impact on options exchanges and on efficiency, competition, and capital formation.

² See CBOE Holdings, Inc., Prospectus Filed Pursuant to Rule 424(b)(4), at 53 (Jun. 15, 2010). The Proposing Release defines "access fee" as "any fee, no matter what it is called, charged to any person for the execution of an incoming order against an options exchange's best bid and offer." Proposing Release, 75 Fed. Reg. at 20743 (emphases omitted). CBOE uses the term "transaction fee" in the same sense in this comment.

CBOE earns “transaction fees” through a “traditional” or “Broker Payment” model. Under this model, as described by the Commission, exchanges charge little to no fees for the execution of customer orders, but may charge fees to broker-dealers and certain other market participants who execute orders on the exchange. 75 Fed Reg. at 20743. In addition, “traditional” exchanges charge fees to market makers; these fees are pooled and made available to market makers to pay brokers in exchange for customer order flow. *See id.* at 20740-41. Finally, a “traditional” exchange (such as CBOE) may provide its market makers with opportunities to match the NBBO at another exchange before routing the order out to that exchange.

To some extent, CBOE’s trading volume and the mix of market participants who trade on the exchange are determined by factors outside its control, such as price volatility in the underlying securities and national and international economic and political conditions. The primary factor over which CBOE may exercise some control is the level of transaction fees that it charges market participants as economic conditions change, based in part on its assessment of the incentives needed to attract order flow and liquidity.

As the Commission notes, CBOE’s pricing model differs from the “Make or Take” model adopted more recently by some other exchanges. Under the “Make or Take” model, typically broker-dealers representing customer orders pay a “Take” fee to access displayed quotations on the exchange, and the exchange provides a portion of that “Take” fee as a rebate to market makers for providing liquidity. *See id.* at 20740-41. These two models represent different strategies for attracting order flow to the exchange—one by providing rebates to market makers as incentives to provide liquidity, the other by making it attractive for customers to submit orders to an exchange without paying “Take” fees on each transaction. Competitive pressures (such as the behavior of market makers and customers in response to pricing changes) determine the pricing model that each exchange will adopt, the types of contracts to which that pricing model will be applied, and the level of fees or rebates that will best attract order flow.

In addition to using transaction fees to provide incentives for various market participants to trade on the exchange, CBOE also relies upon the fees to recoup operating costs incurred as a result of its responsibilities as a self-regulatory organization (“SRO”), to recoup licensing costs

incurred on options products that use third-party proprietary indexes as benchmarks (such as the S&P 500), and to generate returns on its investments for its own popular proprietary products.³ Thus, the access fee cap proposed by the Commission would not only eliminate transaction fee revenues that CBOE depends upon, but would also provide a disincentive for CBOE to develop and market proprietary options products in the future, as discussed further below.

In sum, CBOE needs flexibility to adjust its fees in the face of shifting economic conditions, to compete with other exchanges for market share, and to maintain the health of its business. As shown in these comments, an arbitrary \$0.30 cap on “access” or “transaction” fees would require significant changes in current industry practice, cost CBOE millions of dollars in revenue, and hamper its ability to compete with other options exchanges and futures exchanges.

II. There Is No Need Or Justification For Imposing Price Controls On Options Fees.

Government-imposed price controls are a rare and particularly intrusive form of regulatory action.⁴ They conflict with the very concept of a market-based system, and with

³ A prominent example is the development of options contracts related to the CBOE Volatility Index (“VIX”), a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, VIX has been considered by many to be the world’s premier barometer of investor sentiment and market volatility. VIX options are increasingly popular with investors and volume continues to grow at an impressive rate.

⁴ Direct federal oversight of pricing has been in disfavor among economists and regulators for more than a generation. “[T]he ‘public utility’ cost-based ratemaking approach,” for example, “is resource-intensive, involves arbitrary judgments on appropriate costs, and creates distortive economic incentives.” Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change, at § VII.D.3 (SEC Sept. 14, 2001). See also Stephen G. Breyer, *Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reforms*, 92 HARV. L. REV. 547, 565 (1979) (“insofar as one advocates price regulation . . . as a ‘cure’ for market failure, one must believe the market is working very badly before advocating regulation as a cure. Given the inability of regulation to reproduce the competitive market’s price signals, only severe market failure would make the regulatory game worth the candle.”); Richard B. Stewart, *Reconstitutive Law*, 46 MD. L. REV. 86, 88 (1986) (“the shift from federal price and entry controls in transportation, finance, and communications to reliance on competitive markets policed by antitrust law has created

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Congress's and the Commission's expressed preference for relying on competition to determine prices in our national market system for securities.

As explained below, the Proposing Release has failed to marshal the evidence necessary to justify the extraordinary step of imposing price controls on the options markets. By the Commission's own acknowledgment, the options markets are competitive. There is no evidence that options exchange fees—all of which have been filed with the Commission for review—are improperly opportunistic or excessive. There is also no evidence that the reported opportunistic pricing by “outlier” trading platforms that prompted the Commission to impose price caps in the stock market exists in the options market. Moreover, significant differences exist between the options markets and equities markets that make it erroneous to assume that the cap imposed on equity fees in Regulation NMS—a rule that itself drew a dissent by two Commissioners—would be appropriate for the options markets. Rather, the cap would have significant adverse consequences.

A. The Commission Has Not Established The Existence Of Improper Opportunistic Pricing Or Market Failure In The Options Market.

It is the essence of a market-based economy that prices are determined by supply and demand and interactions in the marketplace, not by the government. Accordingly, when Congress charged the Commission with supervising the development of a “national market system” for securities, a premise of its action was that prices ordinarily would be determined by market forces. *See, e.g.*, H.R. Rep. No. 94-229, at 92 (1975) (Conf. Rep.) (stating Congress's intent that the “national market system evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed”).

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enormous benefits for consumers”); Richard J. Pierce, Jr., *Reconciling Chevron and Stare Decisis*, 85 GEO. L.J. 2225, 2232 (1997) (“Regulatory scholars have long recognized that command and control regulation is both ineffective and inefficient.”); Herbert Hovenkamp, *Book Review: The Takings Clause and Improvident Regulatory Bargains*, 108 YALE L.J. 801, 827 (1999) (noting that “the many defects of cost-of-service ratemaking have been a standard if not completely uncontroversial part of the literature for well over three decades”).

Consistent with this, Congress and the Commission have repeatedly stated their preference for competition, rather than regulatory intervention, to determine prices, products, and services in the securities markets. *See* S. Rep. No. 94-75, 94th Cong., 1st Sess. 8 (1975) (“The objective [in enacting the 1975 amendments to the Exchange Act] would be to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations in practices and services.”); Order Approving Proposed Rule Change Relating to NYSE Arca Data, Release No. 34-59039, 73 Fed. Reg. 74770, 74781 (Dec. 9, 2008) (“The Exchange Act and its legislative history strongly support the Commission’s reliance on competition, whenever possible, in meeting its regulatory responsibilities for overseeing the SROs and the national market system. Indeed, competition among multiple markets and market participants trading the same products is the hallmark of the national market system.”); Regulation NMS, 70 Fed. Reg. at 37499 (observing that NMS regulation “has been remarkably successful in promoting market competition in [the] forms that are most important to investors and listed companies”).

The Commission repeats that premise in the Proposing Release, stating: “[M]arket forces and the dynamics of competition should determine the level of exchange fees whenever possible.” Proposing Release, 75 Fed. Reg. at 20742. And, the Release adds, “currently, the options exchanges are competitive.” *Id.* at 20756.

That assessment is correct. There are more options exchanges now than ever before, with no single exchange commanding more than 35% of listed options market share, a very different picture than 10 or 20 years ago. Access to exchange quotes is also more efficient than ever. Orders are processed and executed electronically in milliseconds (also very different than 10 years ago) and markets are more open to new users than ever before.

The competition that exists among options exchanges exerts competitive pressure on the exchanges’ transaction fees. Under the NMS plan for order protection in listed options (“Options Linkage Plan”), each participating options exchange is required “to establish, maintain, and enforce written policies and procedures as approved by the Commission that are

reasonably designed to prevent Trade-Throughs” in each exchange’s listed options contracts.⁵ When more than one exchange is displaying the NBBO (which is overwhelmingly the case), brokers often assign lowest priority in their order routing tables to the exchange with the highest transaction fees. This means that if an exchange sets high fees, it risks losing business to exchanges with lower fees—the same competitive pressure used by our free markets every day to constrain price. Indeed, order routers’ ability to effectively view all exchanges’ displayed prices simultaneously and execute at the exchange that charges the lowest fees is *more* disciplining than the market forces that operate in many other industries. A customer in the market for a new microwave, for instance, cannot simultaneously know the price of every microwave in the market. And even if all those prices were known, transaction costs often would prevent the customer from buying at the lowest price—perhaps the cheapest microwave is on the other side of town, for example. In the options markets, by contrast, order routers can simultaneously view and execute orders at the exchange with the lowest transaction fees when more than one exchange has, or may match, the NBBO. Plus, broker-dealers, who have accepted responsibility for handling orders on behalf of customers, are monitoring displayed quotes. They are typically more sophisticated and better-informed market participants than customers in non-financial markets, and therefore are better able to make the types of decisions that will produce efficient markets and constrain prices.

A further competitive constraint on prices on the options exchanges is the competition among exchanges to attract customers and liquidity providers and increase order flow. Options exchanges compete in a “two-sided” market, that is, they provide a platform for market makers and customers to interact, and an exchange can only be successful by providing the proper

⁵ Joint Industry Plan; Order Approving the National Market System Plan Relating to Options Order Protection and Locked/Crossed Markets Submitted by the Chicago Board Options Exchange, Incorporated, International Securities Exchange, LLC, The NASDAQ Stock Market LLC, NASDAQ OMX BX, Inc., NASDAQ OMS PHLX, Inc., NYSE Amex LLC, and NYSE Arca, Inc., Release No. 34-60405, 74 Fed. Reg. 39362, 39364-65 (Aug. 6, 2009).

incentives for both types of market participants to trade on the exchange.⁶ In “two-sided” markets, “pricing to one side of the market depends not only on the demand and costs that [one set of] consumers bring but also on how their participation affects participation on the other side and the profit that is extracted from that participation.”⁷ Therefore, the optimal price for exchange transaction fees will depend on the sensitivity of both market makers and customers to changes in price, and the effect that increased participation by one group will have on the attractiveness of the exchange for the other group.⁸ For example, an exchange using “Make or Take” pricing might find it attractive to increase “Take” fees, so it can provide its market makers with higher rebates and attract more liquidity. But pushed too far, that strategy would put the exchange at a competitive disadvantage with customers who want to pay the lowest possible transaction fees—brokers who are routing customer orders would assign low routing priority to the exchange in favor of other exchanges that have lower “Take” fees or apply a “Broker Payment” model. Similarly, if “Broker Payment” exchanges overcharge market makers for order flow, liquidity would contract, as market makers posted on “Make or Take” exchanges.

Because options exchange transaction fees upset the sensitive balances of a two-sided market, regulating the fees is a much more nuanced—and potentially perilous—enterprise than regulating a “single-sided” market. Public utilities, for example, were typically local monopolists for whom the socially “optimal” price was based simply upon the cost of providing

⁶ See Jean-Charles Rochet & Jean Tirole, *Two-Sided Markets: A Progress Report*, 37 RAND J. ECON. 645, 664-65 (Autumn 2006) (“A market is two-sided if the platform can affect the volume of transactions by charging more to one side of the market and reducing the price paid by the other side by an equal amount; in other words, the price structure matters, and platforms must design it so as to bring both sides on board.”).

⁷ Marc Rysman, *The Economics of Two Sided Markets*, 23 J. OF ECON. PERSPECTIVES 125, 129 (Summer 2009).

⁸ See David S. Evans & Richard Schmalensee, *The Industrial Organization of Markets with Two-Sided Platforms*, 3 COMPETITION POL’Y INT’L 160 (Spring 2007) (“The optimal prices [in ‘two-sided’ markets] depend in a complex way on the price sensitivity of demand on both sides, the nature and intensity of the indirect network effects between the two sides, and the marginal costs that result from changing output of each side.”).

a service and the demand for that service.⁹ In two-sided markets, by contrast, “[e]ven if one were convinced . . . that current [transaction] fees are too high, unlike the public utility case, there is no guarantee that lowering them toward any particular target will improve welfare.” Evans & Schmalensee, *supra* n.9, at 102. That is because the optimal transaction fee in a “two-sided” market is a function not merely of the costs incurred by the exchange in providing the trading platform, but also of the incentives that different fees will have on market participants’ decision to choose a particular trading platform to execute orders.

Options exchanges have adopted different pricing models (“Make or Take” or “Broker Payment”) based on their competitive assessment of the incentives that will best attract order flow and liquidity. If the prices charged to either side of the market under those models are altered by regulation, it will upset the model’s achievement of its objective, *i.e.*, to attract liquidity and orders. The Commission’s proposed fee cap would thus introduce inefficiencies into the options market by restricting the ability of exchanges to adjust their pricing models to provide optimal incentives for market makers and customers. By narrowing the choices at the exchanges’ disposal, the proposal would hinder competition from achieving one of its signature benefits, *i.e.*, allowing the marketplace to determine which pricing model best serves consumer needs. As shown below, moreover, it is doubtful the public will receive a countervailing benefit in return.

In proposing the exceptional step of federal price controls, the Commission does not cite any actual evidence of market failure, but identifies the asserted *possibility* that exchanges will take advantage of the Trade-Through Rules and charge exorbitant fees for trades that are required to be routed to access the best displayed quote. *See* 75 Fed. Reg. at 20755. As expressed in Regulation NMS, the concern is that “[o]utlier markets might well try to take advantage of intermarket price protection by acting essentially as a toll booth between price

⁹ *See* David S. Evans & Richard Schmalensee, *The Economics of Interchange Fees and Their Regulation*, in INTERCHANGE FEES IN CREDIT AND DEBIT CARD INDUSTRIES 73, 94-95 (2005). Of course, as noted above (*supra* n.4), “even in these near-textbook cases, economic welfare in practice was not reliably improved by government ownership or price regulation.” *Id.* at 95.

levels,” *id.* at 37545, that is, “outlier” exchanges with few available shares at the best displayed price would charge exorbitant access fees, which brokers would be forced to access before seeking deeper liquidity at the next price level on another exchange. Mere speculation regarding theoretical potential abuse, however, without actual evidence of a market failure that enables exchanges to engage in improper opportunistic behavior, cannot justify government-imposed price controls. *See, e.g., Horsehead Resource Dev. Co. v. Browner*, 16 F.3d 1246, 1269 (D.C. Cir. 1994) (“speculation is an inadequate replacement for the agency’s duty to undertake an examination of the relevant data and reasoned analysis,” and reliance on speculation is “arbitrary and capricious” under the APA); *Natural Res. Def. Council, Inc. v. EPA*, 859 F.2d 156, 210 (D.C. Cir. 1988) (where agency “offers no more than mere speculation to support its conclusion,” it fails to provide “adequate grounds upon which to sustain [] agency[] action”).

When the Commission adopted a similar fee cap for equities in Regulation NMS, it cited evidence of what it perceived to be anti-competitive pricing behavior. *See, e.g., 70 Fed. Reg.* at 37545 (noting one exchange’s purported practice of charging high fees selectively to competitors); *id.* at 37547 (citing evidence of locked and crossed markets in equities). No such evidence has been cited here. To the contrary, there is every indication that no such pricing strategies exist. The best bid and offer is deeper and changes frequently to reflect underlying stock prices as well as supply and demand, making options orders less likely to exhaust liquidity at the best quote and trade at the next price level. In addition, as the Commission notes, the options market is characterized by robust competition for order volume, which is fairly evenly distributed between the four largest entities that own exchanges: CBOE (29.58%), ISE (22.86%), NYSE Euronext (25.82% combined market share), and The NASDAQ OMX Group, Inc. (19.76% combined market share). *Proposing Release*, 75 Fed. Reg. at 20759. None of these four entities (which control over 98% of the market) could afford to charge opportunistic fees that resulted in being placed at the bottom of an order routing table and losing market share to competitors.

There also is no evidence that the smaller exchanges (BOX or BATS) engage in the improper opportunistic “toll booth” pricing behavior hypothesized in Regulation NMS and by some commentators. Speculation about dubious pricing strategies affecting less than 2% of

