

## SECURITIES AND EXCHANGE COMMISSION

Release No. 34-72693

July 28, 2014

### Order Granting a Limited Exemption from Rule 102 of Regulation M Concerning the BATS Exchange, Inc.'s Pilot Supplemental Competitive Liquidity Provider Program

The Securities and Exchange Commission (“Commission”) approved a proposed rule change of the BATS Exchange, Inc. (“Exchange” or “BATS”) to add new Interpretation and Policy .03 to Rule 11.8 (“New IP .03”) which establishes the Supplemental Competitive Liquidity Provider (“CLP”) Program (“CLP Program” or “Program”) effective for one year on a pilot basis (the “pilot”). The CLP Program permits certain market makers to become CLPs (“ETP CLPs”) in exchange-traded products (“ETPs”).<sup>1</sup> The Exchange states that the CLP Program is designed to incentivize quoting volume in certain ETPs by providing credit to CLPs for certain market making activity.<sup>2</sup> Participating issuers (or sponsors on behalf of the issuer) fund the Program by paying non-refundable “CLP Fees,” which are then credited to the Exchange’s general revenues.<sup>3</sup> The Commission believes that payment of the CLP Fee by the

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<sup>1</sup> See New IP .03(f) (establishing the qualifications to be a CLP); see also Securities Exchange Act Release No. 72692 (July 28, 2014) (SR-BATS 2014-022) (“Approval Order”) (providing more details regarding the Program).

<sup>2</sup> See Approval Order. The Approval Order contains a detailed description of the Program. The proposed rule change was published for comment in the Federal Register on June 13, 2014. Securities Exchange Act Release No. 72346 (Jun. 9, 2014), 79 FR 33982 (Jun. 13, 2014). The Approval Order grants approval of the proposed rule change.

<sup>3</sup> The program is similar to other programs, such as NYSE Arca’s “ETP Incentive Program” and NASDAQ Stock Market LLC’s “Market Quality Program,” designed to permit ETP issuers to pay incentives to those who make markets in their ETPs. See Securities Exchange Act Release No. 69706 (June 6, 2013); 78 FR 35340 (June 12, 2013) (NYSEArca 2013-34) and Securities Exchange Act Release No. 69195 (Mar. 20, 2013); 78 FR 18393 (Mar. 26, 2013) (NASDAQ 2012-137); see also Securities Exchange Act Release No. 69707 (June 6, 2013); 78 FR 35330 (June 12, 2013) (approving a limited

issuer (or a sponsor on behalf of the issuer) for the purpose of incentivizing market makers to participate as a CLP in the issuer's otherwise less liquid securities would constitute an indirect attempt by the issuer to induce a bid for or a purchase of a covered security during a restricted period.<sup>4</sup> As a result, absent exemptive relief, participation in the CLP Program by an issuer (or sponsor on behalf of the issuer) would violate Rule 102 of Regulation M.<sup>5</sup> This order grants a limited exemption from Rule 102 of Regulation M solely to permit issuers and sponsors to participate in the Program during the pilot, subject to certain conditions described below.

BATS stated that the CLP Program is designed to incentivize market makers to quote in certain ETPs.<sup>6</sup> An issuer of an ETP that participates in the CLP Program would elect to pay a CLP Fee to BATS in an amount ranging from \$10,000 to \$100,000 per year, with the actual

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exemption from Rule 102 of Regulation M concerning NYSE Arca's ETP Incentive Program Pilot); Securities Exchange Act Release No. 69196 (Mar. 20, 2013); 78 FR 18410 (Mar. 26, 2013) (approving a limited exemption from Rule 102 of Regulation M concerning NASDAQ Stock Market LLC's Market Quality Program Pilot); and Securities Exchange Act Release No. 71805 (Mar. 26, 2014); 78 FR 18365 (Apr. 1, 2014) (approving a limited exemption from Rule 102 of Regulation M concerning NYSE Arca's Crowd Participant Program Pilot).

<sup>4</sup> See Securities Exchange Act Release No. 67411 (July 11, 2012), 77 FR 42052 (July 17, 2012) (stating that "[t]he Commission believes that issuer payments made under the [similar ETP Incentive and Market Quality Programs] would constitute an indirect attempt by the issuer of a covered security to induce a purchase or bid in a covered security during a restricted period in violation of Rule 102" and that "[u]nder the [similar ETP Incentive Program], the purpose of the Program is 'to create [an incentive program] for issuers of certain ETPs listed' on NYSE Arca, which ... could induce bids or purchases for the issuer's security during a restricted period"). Similarly, the issuer pays for the Program for the stated purpose of incentivizing market makers to quote in certain ETPs, which also could induce bids or purchases for the issuer's security during a restricted period. See Approval Order.

<sup>5</sup> 17 CFR 242.102.

<sup>6</sup> See Approval Order.

amount above \$10,000 to be determined by the issuer.<sup>7</sup> The CLP Fee is in addition to the current standard listing fee applicable to the ETP and is paid by the issuer to the Exchange's general revenues.<sup>8</sup> Subject to the requirements set forth in New IP .03, the amount of a total daily payment available to CLPs ("CLP Rebate") will be equal to one quarter of the total annual CLP Fees (basic and supplemental combined) for the security participating in the Program ("CLP Security") divided by the number of trading days in the current quarter.<sup>9</sup> If no CLP is eligible to receive a CLP Rebate because the CLP Program performance standards were not met by any CLP, no CLP would receive a CLP Rebate.<sup>10</sup> The voluntary Program established by New IP .03 will be effective for one year on a pilot basis.<sup>11</sup>

The Exchange will provide notification on its website regarding the following: (i) acceptance of a CLP Company,<sup>12</sup> on behalf of a CLP Security, or a CLP into the Program; (ii) the total number of CLP Securities that any one CLP Company may have in the Program; (iii) the names of CLP Securities and the CLP(s) in each CLP Security, the dates that a CLP Company, on behalf of a CLP Security, commences participation in and withdraws or is terminated from the Program, and the name of each CLP Company and its associated CLP Security or Securities; (iv) a statement about the Program that sets forth a general description of

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<sup>7</sup> See Approval Order.

<sup>8</sup> Id.

<sup>9</sup> Id.; see also New IP .03(m)(1). In the Approval Order, the following example is provided: Where the total CLP Fees for a CLP Security is \$64,000 and there are 64 trading days in the current quarter, the total CLP Rebate for the CLP Security would be \$250 ((64,000/4)/64).

<sup>10</sup> See Approval Order.

<sup>11</sup> New IP .03(p).

<sup>12</sup> CLP Company is defined in New IP .03(b)(2) as "the trust or company housing the ETP or, if the ETP is not a series of a trust or company, then the ETP itself..."

the Program as implemented on a pilot basis and a fair and balanced summation of the potentially positive aspects of the Program (e.g., enhancement of liquidity and market quality in CLP Securities) as well as the potentially negative aspects and risks of the Program (e.g., possible lack of liquidity and negative price impact on CLP Securities that are withdrawn or are terminated from the Program), and indicates how interested parties can get additional information about CLP Securities in the Program; and (v) the intent of a CLP Company, on behalf of a CLP Security, or the CLP to withdraw from the Program, and the date of actual withdrawal or termination from the Program.<sup>13</sup> In addition, a CLP Company that, on behalf of a CLP Security, is approved to participate in the Program shall issue a press release to the public when the CLP Company, on behalf of a CLP Security, commences or ceases participation in the Program.<sup>14</sup> The press release shall be in a form and manner prescribed by the Exchange, and, if practicable, shall be issued at least two days before commencing or ceasing participation in the Program.<sup>15</sup> The CLP Company shall dedicate space on its website, or, if it does not have a website, on the website of the Sponsor of the CLP Security, which space will (i) include any such press releases, and (ii) provide a hyperlink to the dedicated page on the Exchange's website that describes the Program.<sup>16</sup>

The Commission received no comments on the proposal.<sup>17</sup> However, certain commenters expressed concerns about similar ETP Incentive and Market Quality Programs,<sup>18</sup>

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<sup>13</sup> See New IP .03(o).

<sup>14</sup> See New IP .03(d)(4).

<sup>15</sup> Id.

<sup>16</sup> Id.

<sup>17</sup> See Approval Order.

including the departure from rules precluding market makers from directly or indirectly accepting payment from an issuer of a security for acting as a market maker.<sup>19</sup> In particular, commenters to those similar proposals discussed the potential distortive impact on the natural market forces of supply and demand.<sup>20</sup> Commenters to those proposals also discussed what they viewed as the failure of those programs, as originally conceived, to adequately mitigate their potential negative impacts.<sup>21</sup>

For example, one commenter stated that “[i]ssuer payments to market makers have the potential to distort market forces, resulting in spreads and prices that do not reflect actual supply

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<sup>18</sup> See note 3, *supra*.

<sup>19</sup> See, e.g., Letter from Gus Sauter, Managing Director and Chief Investment Officer, Vanguard, dated June 7, 2012 (citing to his comment letter regarding the similar NASDAQ Market Quality Program, in which he stated, “The additional factor of payments by an issuer to a market maker would probably be viewed as a conflict of interest since it would undoubtedly influence, to some degree, a firm’s decision to make a market and thereafter, perhaps, the prices it would quote. Hence, what might appear to be independent trading activity may well be illusory.”). In addition, another commenter noted “that market maker incentive programs, such as the [NYSE Arca ETP Incentive Program], represent a departure from the current rules precluding market makers from accepting payment from an issuer of a security for acting as a market maker” yet supported the concept of market maker incentive programs on a pilot basis. Letter from Ari Burstein, Investment Company Institute (“ICI”), dated June 7, 2012. In a subsequent letter, however, the same commenter noted that certain of its members opposed the Program as originally proposed and stated that it “could create a ‘pay-to-play’ environment.” Letter from Ari Burstein, ICI, dated Aug. 16, 2012. The Approval Order also notes that a number of aspects of the Program mitigate the concerns that the rule in question, FINRA Rule 5250 (Payments for Market Making), were designed to address.

<sup>20</sup> See, e.g., Letter from F. William McNabb, Chairman and Chief Executive Officer, Vanguard, dated Aug. 16, 2012.

<sup>21</sup> See, e.g., Letter from Gus Sauter, Managing Director and Chief Investment Officer, Vanguard, dated June 7, 2012.

and demand.”<sup>22</sup> Another commenter questioned whether any safeguards could alleviate their concerns regarding issuer payments to market makers.<sup>23</sup> Another commenter questioned whether information relating to the similar Market Quality Program posted to that exchange’s website in a similar manner as required in New IP .03 by BATS would adequately address investor protection and market integrity concerns because investors may not search an exchange website for important information about a particular ETP.<sup>24</sup>

### **Rule 102 of Regulation M**

Rule 102 of Regulation M prohibits issuers, selling security holders, or any affiliated purchaser of such persons, directly or indirectly, from bidding for, purchasing, or attempting to induce any person to bid for or purchase a covered security<sup>25</sup> during the applicable restricted period in connection with a distribution of securities effected by or on behalf of an issuer or selling security holder, except as specifically permitted in the rule.<sup>26</sup> As mentioned above, the Commission believes that the payment of the CLP Fee would constitute an indirect attempt to

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<sup>22</sup> Letter from F. William McNabb, Chairman and Chief Executive Officer, Vanguard, dated Aug. 16, 2012.

<sup>23</sup> Letter from Ari Burstein, ICI, dated Aug. 16, 2012 (stating that “ICI members who oppose the Programs believe any fixes to the proposed parameters will be insufficient to address their overall concerns with market maker incentive programs”).

<sup>24</sup> Letter from Gus Sauter, Managing Director and Chief Investment Officer, Vanguard, dated (May 3, 2012) (asking whether it is likely that investors would consult NASDAQ’s website for information about which ETFs and market makers are participating in the NASDAQ Market Quality Program given what is known about investor behavior and, if not, asserting that “most investors would not be able to distinguish quotations that reflect true market forces from quotations that have been influenced by issuer payments”).

<sup>25</sup> Covered security is defined as any security that is the subject of a distribution, or any reference security. 17 CFR 242.100(b).

<sup>26</sup> 17 CFR 242.102(a).

induce a bid for or purchase of a covered security during the applicable restricted period.<sup>27</sup> As a result, absent exemptive relief, participation in the Program by a sponsor or issuer would violate Rule 102.

On the basis of the conditions set out below and the requirements set forth in New IP .03, which in general are designed to help inform investors about the potential impact of the Program, the Commission finds that it is appropriate in the public interest, and is consistent with the protection of investors, to grant a limited exemption from Rule 102 of Regulation M solely to permit the payment of the CLP Fee as set forth in New IP .03 during the pilot.<sup>28</sup> This limited exemption is conditioned on a requirement that the security participating in the Program is an ETP and the secondary market price for shares of the ETP must not vary substantially from the net asset value of such ETP shares during the duration of the ETP's participation in the Program. This condition is designed to limit the Program to ETPs that have a pricing mechanism that is expected to keep the price of the ETP shares tracking the net asset value of the ETP shares, which should make the shares less susceptible to price manipulation.

This limited exemption is further conditioned on disclosure requirements, as set forth below, which are designed to alert potential investors that the trading market for the otherwise less liquid securities in the Program may be affected by participation in the Program. By making it easier for investors to be able to distinguish which quotations may have been influenced by the CLP Fee from those that have not, and by requiring the issuers and sponsors to provide information on the potential effect of Program participation on the price and liquidity of a

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<sup>27</sup> See note 3, *supra*.

<sup>28</sup> Rule 102(e) allows the Commission to grant an exemption from the provision of Rule 102, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities.

security participating in the Program, the required enhanced disclosure requirements are designed to inform potential investors about the potential distortive impact of the CLP Fee on the natural market forces of supply and demand. The general disclosures required by New IP .03, while helpful, may not be sufficient to obtain this result.<sup>29</sup> The required enhanced disclosures are expected to promote greater investor protection by helping to ensure that investors will have easier access to important information about a particular ETP.<sup>30</sup>

As a practical matter, these requirements are not intended to be duplicative with the issuer disclosures required by New IP .03. These requirements can be satisfied via the press release and dedicated webpage required by New IP .03(d)(4), however, these materials must contain all the required disclosures outlined below, and be in the manner stated in the condition, in addition to any requirements of the Exchange. Issuers or sponsors of products that are not registered under the Investment Company Act of 1940, as amended (“1940 Act”), may also meet the press release requirements of these enhanced disclosures in a manner compliant with Regulation FD (other than website only disclosure).<sup>31</sup> We also note that, to the extent that information about participation in the Program is material, disclosure of this kind may already be required by the federal securities laws and rules.

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<sup>29</sup> New IP .03(d)(4) does not contain any specific content requirements for issuer or sponsor disclosure, other than a “press release” when entering or leaving the Program and a hyperlink on a dedicated issuer, advisor, or sponsor’s webpage to the Exchange’s website that contains a number of specific disclosures about the program. As outlined below, the enhanced disclosures required of the issuer or sponsor as conditions to this order require that the issuer’s or sponsor’s press release and webpage directly contain a number of helpful disclosures for investors, including risks of the program.

<sup>30</sup> The required website and press release disclosures should be less burdensome than other methods of notifying investors of a security’s participation in the Program, such as requiring a ticker symbol identifier or flagging participating CLP quotes and trades.

<sup>31</sup> See condition (4), infra.



## **Conclusion**

IT IS THEREFORE ORDERED, that issuers or sponsors who pay a CLP Fee are hereby exempted from Rule 102 of Regulation M solely to permit the payment of the CLP Fee as set forth in New IP .03 in connection with a security participating in the Program during the pilot, subject to the conditions contained in this order and compliance with the requirements of New IP .03.

This exemption is subject to the following conditions:

1. The security participating in the Program is an ETP and the secondary market price for shares of the ETP must not vary substantially from the net asset value of such ETP shares during the duration of the security's participation in the Program;
2. The issuer of the participating ETP, or sponsor on behalf of the issuer, must provide prompt notice to the public by broadly disseminating a press release prior to entry (or upon re-entry) into the Program. This press release must disclose:
  - a. The payment of a CLP Fee is intended to generate more quotes and trading than might otherwise exist absent this payment, and that the security leaving the Program may adversely impact a purchaser's subsequent sale of the security; and
  - b. A hyperlink to the webpage described in condition (5) below;
3. The issuer of the participating ETP, or sponsor on behalf of the issuer, must provide prompt notice to the public by broadly disseminating a press release prior to a security leaving the Program for any reason, including termination of the Program. This press release must disclose:

- a. The date that the security is leaving the Program and that leaving the Program may have a negative impact on the price and liquidity of the security which could adversely impact a purchaser's subsequent sale of the security; and
  - b. A hyperlink to the webpage described in condition (5) below;
4. In place of the press releases required by conditions (2) and (3) above, an issuer of a participating ETP that is not registered under the 1940 Act, or sponsor on behalf of the issuer, may provide prompt notice to the public through the use of such other written Regulation FD compliant methods (other than website disclosure only) that is designed to provide broad public dissemination as provided in 17 CFR 243.101(e), provided, however, that such other methods must contain all the information required to be disclosed by conditions (2) and (3) above;
5. The issuer of the participating ETP, or sponsor on behalf of the issuer, must provide prompt, prominent and continuous disclosure on its website in the location generally used to communicate information to investors about a particular security participating in the Program, and for a security that has a separate website, the security's website of:
  - a. The security participating in the Program and ticker, date of entry into the Program, and the amount of the CLP Fee;
  - b. Risk factors investors should consider when making an investment decision, including that participation in the Program may have potential impacts on the price and liquidity of the security; and
  - c. Termination date of the pilot, anticipated date (if any) of the security leaving the Program for any reason, date of actual exit (if applicable), and that the

security leaving the Program could adversely impact a purchaser's subsequent sale of the security; and

6. The website disclosure in condition (5) above must be promptly updated if a material change occurs with respect to any information contained in the disclosure.

This exemptive relief expires when the pilot terminates, and is subject to modification or revocation at any time the Commission determines that such action is necessary or appropriate in furtherance of the purposes of the Exchange Act. This exemptive relief is limited solely to the payment of the CLP Fee as set forth in New IP .03 for a security that is an ETP participating in the Program,<sup>32</sup> and does not extend to any other activities, any other security of the trust related

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<sup>32</sup> All ETPs that are allowed to participate in the Program have a pool of underlying assets. See New Rule 7.25(b)(2). Should the Program be modified to include other ETPs, such as exchange-traded notes, that do not have a pool of underlying assets, the Commission would consider this a material change and outside the scope of this exemptive relief.

to the participating ETP, or any other issuers.<sup>33</sup> In addition, persons relying on this exemption are directed to the anti-fraud and anti-manipulation provisions of the Exchange Act, particularly Sections 9(a) and 10(b), and Rule 10b-5 thereunder. Responsibility for compliance with these and any other applicable provisions of the federal securities laws must rest with the persons relying on this exemption. This order does not represent Commission views with respect to any other question that the proposed activities may raise, including, but not limited to the adequacy of the disclosure required by federal securities laws and rules, and the applicability of other federal or state laws and rules to, the proposed activities.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>34</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>33</sup> Other activities, such as ETP redemptions, are not covered by this exemptive relief.

<sup>34</sup> 17 CFR 200.30-3(a)(6).