

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-72692; File No. SR-BATS-2014-022)

July 28, 2014

Self-Regulatory Organizations; BATS Exchange, Inc.; Order Granting Approval of a Proposed Rule Change to Amend the Competitive Liquidity Provider Program

On June 3, 2014, BATS Exchange, Inc. (“Exchange” or “BATS”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “Exchange Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to add Interpretation and Policy .03 to Rule 11.8 to establish the Supplemental Competitive Liquidity Provider Program (“Program”) for Exchange Traded Products (“ETPs”) listed on the Exchange for a one year pilot period, and to amend Interpretation and Policy .02 to Rule 11.8, which governs the existing Competitive Liquidity Provider Program (“CLP Program”), to reflect the transition for Exchange-listed ETPs from the existing CLP Program to the proposed Program. The proposed rule change was published for comment in the Federal Register on June 13, 2014.<sup>3</sup> The Commission did not receive any comment letters on the proposed rule change. This order grants approval of the proposed rule change.<sup>4</sup>

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

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

<sup>3</sup> Securities Exchange Act Release No. 72346 (Jun. 9, 2014), 79 FR 33982 (“Notice”).

<sup>4</sup> Today the Commission also is granting exemptive relief from Rule 102 under Regulation M concerning the Program. See Securities Exchange Act Release No. 72693 (Jul. 28, 2014) (Order Granting a Limited Exemption from Rule 102 of Regulation M Concerning the BATS Exchange, Inc.’s Supplemental Competitive Liquidity Provider Program Pilot Pursuant to Regulation M Rule 102(e)).

I. Description of the Proposal

As set forth in more detail in the Notice,<sup>5</sup> the Exchange is proposing to amend its rules to add Interpretation and Policy .03 to Rule 11.8 to establish the Program, which seeks to incentivize certain Market Makers registered with the Exchange (“Market Makers”)<sup>6</sup> as ETP Competitive Liquidity Providers (“ETP CLPs”)<sup>7</sup> to enhance liquidity on the Exchange in certain Exchange-listed ETPs<sup>8</sup> and thereby qualify to receive part of a daily rebate pursuant to the Program (a “CLP Rebate”).<sup>9</sup> As proposed, the Program will operate for a one year pilot period beginning from the date of implementation of the Program.<sup>10</sup> The Exchange is also proposing to amend Interpretation and Policy .02 to Rule 11.8 (Competitive Liquidity Provider Program)<sup>11</sup> to

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<sup>5</sup> See Notice, supra note 3.

<sup>6</sup> As defined in BATS Rules, the term “Market Maker” means a Member that acts as a market maker pursuant to Chapter XI of BATS Rules.

<sup>7</sup> As defined in proposed Interpretation and Policy .03(b)(1) to Rule 11.8, the term “ETP CLP” means a Member that electronically enters proprietary orders into the systems and facilities of the Exchange and is obligated to maintain a bid or an offer at the NBBO in each assigned CLP Security in round lots consistent with paragraph (i) of Interpretation and Policy .03 to Rule 11.8.

<sup>8</sup> As proposed in Interpretation and Policy .03(b)(4) to Rule 11.8, the term “ETP” includes Portfolio Depository Receipts, Index Fund Shares, Trust Issued Receipts, and Managed Fund Shares, which are defined in Rule 14.11(b), 14.11(c), 14.11(f), and 14.11(i), respectively.

<sup>9</sup> See Notice, supra note 3, 79 FR at 33982.

<sup>10</sup> See proposed Interpretation and Policy .03(p) to Rule 11.8.

<sup>11</sup> The Exchange currently operates the existing CLP Program, which is designed to incentivize certain Market Makers registered with the Exchange as Competitive Liquidity Providers to enhance liquidity on the Exchange in all Exchange-listed securities, including ETFs. See Securities Exchange Act Release No. 66307 (February 2, 2012), 77 FR 6608 (February 8, 2012) (SR-BATS-2011-051) (order approving proposed rule change to implement the Competitive Liquidity Provider Program). See also Securities Exchange Act Release Nos. 66427 (February 21, 2012), 77 FR 11608 (February 27, 2012) (SR-BATS-2012-011) (Notice of filing and immediate effectiveness of proposed rule change adopting rebates for the CLP Program); 67854 (September 13, 2012), 77 FR 58198 (September 19, 2012) (SR-BATS-2012-036) (Notice of filing and immediate

reflect the transition for Exchange-listed ETPs from the existing CLP Program to the proposed Program.

The Exchange plans to implement the Program and the corresponding amendments to existing Interpretation and Policy .02 to Rule 11.8 on a date that will be circulated in a notice from the BATS Trade Desk.<sup>12</sup> The Exchange proposes to maintain existing Interpretation and Policy .02 in its current form until such implementation, and the Exchange states that it will notify all interested parties of the implementation date of these changes through a notice distributed to all Members of the Exchange.<sup>13</sup>

#### Summary of the Program

The Program is voluntary and is designed to promote market quality in CLP Securities<sup>14</sup>

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effectiveness of proposed rule change related to fees applicable to the CLP Program); 69190 (March 20, 2013), 78 FR 18384 (March 26, 2013) (SR-BATS-2013-005) (Order approving proposed rule change to modify the CLP Program to, among other things, modify the calculation of Size Event Tests); 69857 (June 25, 2013), 78 FR 39392 (July 1, 2013) (SR-BATS-2013-037) (Notice of filing and immediate effectiveness of a proposed rule change to amend the requirements of the CLP Program); 70865 (November 13, 2013), 78 FR 69509 (November 19, 2013) (SR-BATS-2013-057) (Notice of filing and immediate effectiveness of a proposed rule change to amend the CLP Program); and 71284 (January 10, 2014), 79 FR 2921 (January 16, 2014) (SR-BATS-2014-002) (Notice of filing and immediate effectiveness of a proposed rule change to extend the applicability of the CLP Program).

<sup>12</sup> See Notice, supra note 3, 79 FR at 33982.

<sup>13</sup> Id. The Exchange states that it is proposing to provide notice of the implementation date through a notice rather than implementing the changes to the rule immediately upon approval by the Commission in order to provide the Exchange with the flexibility necessary to ensure an uninterrupted transition from the CLP Program to the Program. Id.

<sup>14</sup> As defined in proposed Interpretation and Policy .03(b)(3) to Rule 11.8, the term “CLP Security” means an issue of or series of ETP securities issued by a CLP Company that meets all of the requirements to be listed on the Exchange as an ETP pursuant to Rule 14.11.

by allowing a CLP Company<sup>15</sup> to list an eligible CLP Security on the Exchange and, in addition to paying the standard (non-CLP) listing fee as set forth in the fee schedule, a Sponsor<sup>16</sup> may pay a fee (a “CLP Fee”) in order for the CLP Company, on behalf of a CLP Security, to participate in the Program, which will be credited to the BATS General Fund.<sup>17</sup> The CLP Fee will be used to incentivize one or more ETP CLPs to enhance the market quality of the CLP Security.<sup>18</sup> Subject to the conditions set forth in the proposed rule, the Exchange will pay the CLP Rebate out of the BATS General Fund to one or more ETP CLPs that make a market in the CLP Security.<sup>19</sup>

#### Securities Eligible for the Program

Under the proposal, for a CLP Company, on behalf of a CLP Security, to be eligible to participate in the Program, the following conditions must be satisfied: (i) the Exchange has accepted the Program application of the CLP Company with respect to the CLP Security and the Exchange has accepted the Program application of at least one ETP CLP in the same CLP Security; (ii) the CLP Security meets all requirements to be listed on the Exchange as an ETP; (iii) the CLP Security meets all Exchange requirements for continued listing at all times the CLP Security participates in the Program; and (iv) while the CLP Security is participating in the Program, on a product-specific website, the CLP Company must indicate that the product is in

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<sup>15</sup> As defined in proposed Interpretation and Policy .03(b)(2) to Rule 11.8, the term “CLP Company” means the trust or company housing the ETP or, if the ETP is not a series of a trust or company, then the ETP itself.

<sup>16</sup> As defined in proposed Interpretation and Policy .03(b)(5) to Rule 11.8, “Sponsor” means the registered investment adviser that provides investment management services to a CLP Company or any of such adviser’s parents or subsidiaries.

<sup>17</sup> See proposed Interpretation and Policy .03(a) to Rule 11.8.

<sup>18</sup> Id.

<sup>19</sup> Id.

the Program and provide a link to the Exchange’s Program website.<sup>20</sup> In addition, a CLP Company, on behalf of a CLP Security, is eligible for the Program unless and until such CLP Security has had a consolidated average daily volume (“CADV”) of equal to or greater than one million shares for three consecutive calendar months; however any CLP Security initially listed on the Exchange shall be eligible for the Program for the first six months that it is listed on the Exchange, regardless of the ETP’s CADV.<sup>21</sup> Notwithstanding the foregoing, the Exchange proposes that an ETP participating in the CLP Program under BATS Rule 11.8, Interpretation and Policy .02, shall not be eligible for participation in the Program until and unless such ETP is no longer participating in the CLP Program.<sup>22</sup>

#### Qualifications of ETP CLPs

To qualify as an ETP CLP, a Member must be a registered Market Maker in good standing with the Exchange consistent with Rules 11.5 through 11.8.<sup>23</sup> Further, the Exchange will require each Member seeking to qualify as an ETP CLP to have and maintain: (1) adequate technology to support electronic trading through the systems and facilities of the Exchange; (2) one or more unique identifiers that identify to the Exchange ETP CLP trading activity in assigned CLP Securities;<sup>24</sup> (3) adequate trading infrastructure to support ETP CLP trading

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<sup>20</sup> See proposed Interpretation and Policy .03(d)(1) to Rule 11.8.

<sup>21</sup> See proposed Interpretation and Policy .03(d)(3) to Rule 11.8.

<sup>22</sup> Id.

<sup>23</sup> See proposed Interpretation and Policy .03(f) to Rule 11.8.

<sup>24</sup> A Member may not use such unique identifiers for trading activity at the Exchange in assigned CLP Securities that is not ETP CLP trading activity, but may use the same unique identifiers for trading activity in securities not assigned to an ETP CLP. If a Member does not identify to the Exchange the unique identifier to be used for ETP CLP trading activity, the Member will not receive credit for such ETP CLP trading. See proposed Interpretation and Policy .03(f)(2) to Rule 11.8.

activity, which includes support staff to maintain operational efficiencies in the Program and adequate administrative staff to manage the Member's participation in the Program; (4) quoting and volume performance that demonstrates an ability to meet the ETP CLP quoting requirement in each assigned CLP Security on a daily and monthly basis; and (5) a disciplinary history that is consistent with just and equitable business practices.<sup>25</sup>

### Application

Under the proposal, any entity that wishes to participate in the Program must submit an application in the form prescribed by the Exchange, including both CLP Companies on behalf of a CLP Security and ETP CLPs.<sup>26</sup>

The proposed rule sets forth a specific application process for ETP CLPs.<sup>27</sup> To become an ETP CLP, a Member must submit an application form with all supporting documentation to the Exchange.<sup>28</sup> The Exchange will determine whether an applicant is qualified to become an ETP CLP based on the qualifications set forth in the rule, as described above.<sup>29</sup> After an applicant submits an ETP CLP application to the Exchange, with supporting documentation, the Exchange shall notify the applicant Member of its decision.<sup>30</sup> If an applicant is approved by the Exchange to receive ETP CLP status, such applicant must establish connectivity with relevant Exchange systems before such applicant will be permitted to trade as an ETP CLP on the

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<sup>25</sup> See Proposed Interpretation and Policy .03(f) to Rule 11.8.

<sup>26</sup> See Proposed Interpretation and Policy .03(c)(1) to Rule 11.8.

<sup>27</sup> See Proposed Interpretation and Policy .03(g) to Rule 11.8.

<sup>28</sup> See Proposed Interpretation and Policy .03(g)(1) to Rule 11.8.

<sup>29</sup> See Proposed Interpretation and Policy .03(g)(2) to Rule 11.8.

<sup>30</sup> See Proposed Interpretation and Policy .03(g)(3) to Rule 11.8.

Exchange.<sup>31</sup> In the event an applicant is disapproved by the Exchange, such applicant may seek review under Chapter X of the Exchange's Rules governing adverse action and/or reapply for ETP CLP status at least three (3) calendar months following the month in which the applicant received the disapproval notice from the Exchange.<sup>32</sup>

#### Assignment of CLP Securities

The Exchange, in its discretion, will assign to the ETP CLP one or more CLP Securities for ETP CLP trading purposes.<sup>33</sup> The Exchange shall determine the number of CLP Securities assigned to each ETP CLP.<sup>34</sup> The Exchange, in its discretion, will assign one or more ETP CLPs to each CLP Security subject to the Program, depending upon the trading activity of the CLP Security.<sup>35</sup>

#### ETP CLP Withdrawal & Reallocation

An ETP CLP may withdraw from the status of an ETP CLP by providing written notice to the Exchange. Such withdrawal shall become effective when those CLP Securities assigned to the withdrawing ETP CLP are reassigned to another ETP CLP. After the Exchange receives the notice of withdrawal from the withdrawing ETP CLP, the Exchange will reassign such CLP Securities as soon as practicable but no later than thirty (30) days after the date said notice is received by the Exchange. In the event the reassignment of CLP Securities takes longer than the 30-day period, the withdrawing ETP CLP will have no obligations under Interpretation and Policy .03 and will not be held responsible for any matters concerning its previously assigned

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<sup>31</sup> See Proposed Interpretation and Policy .03(g)(4) to Rule 11.8.

<sup>32</sup> See Proposed Interpretation and Policy .03(g)(5) to Rule 11.8.

<sup>33</sup> See proposed Interpretation and Policy .03(j)(1) to Rule 11.8.

<sup>34</sup> Id.

<sup>35</sup> See proposed Interpretation and Policy .03 (j)(2) to Rule 11.8.

CLP Securities upon termination of this 30-day period.<sup>36</sup>

CLP Security Withdrawal & Renewal; Termination

A CLP Company may, on behalf of a CLP Security, after being in the Program for not less than two consecutive quarters, but less than one year, voluntarily withdraw from the Program on a quarterly basis. The CLP Company must notify the Exchange in writing, not less than one month prior to withdrawing from the Program. The Exchange, however, does retain discretion to allow a CLP Company to withdraw from the Program earlier. In making such a determination, the Exchange may take into account the volume and price movements in the CLP Security; the liquidity, size quoted, and quality of the market in the CLP Security; and any other relevant factors.<sup>37</sup> After a CLP Company, on behalf of a CLP Security, is in the Program for one year or more, it may voluntarily withdraw from the Program on a monthly basis, so long as the CLP Company notifies the Exchange in writing not less than one month prior to withdrawing from the Program.<sup>38</sup> After a CLP Company, on behalf of a CLP Security, is in the Program for one year, the Program and all obligations and requirements of the Program will automatically continue on an annual basis unless: (1) the Exchange terminates the Program by providing not less than one month prior notice of intent to terminate or the pilot Program is not extended or made permanent pursuant to a proposed rule change subject to filing with or approval by the Commission; (2) the CLP Company withdraws from the Program pursuant to the withdrawal rules described above; or (3) the CLP Company is terminated from the Program pursuant to

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<sup>36</sup> See proposed Interpretation and Policy .03(h) to Rule 11.8.

<sup>37</sup> See proposed Interpretation and Policy .03(c)(2)(A) to Rule 11.8.

<sup>38</sup> See proposed Interpretation and Policy .03(c)(2)(B) to Rule 11.8.



subsection (n) of the proposal.<sup>39</sup>

Interpretation and Policy .03 (n) to Rule 11.8 states that the Program will terminate with respect to a CLP Security under the following circumstances: (a) a CLP Security sustains a CADV of one million shares or more for three consecutive months; however, any CLP Security initially listed on the Exchange shall be eligible for the Program for the first six months that it is listed on the Exchange, regardless of the CLP Security's CADV; (b) a CLP Company, on behalf of a CLP Security, withdraws from the Program, is no longer eligible to be in the Program pursuant to the proposed rule, or its Sponsor ceases to make CLP Fee payments to the Exchange; (c) a CLP Security is delisted or is no longer eligible for the Program; or (d) a CLP Security does not, for two consecutive quarters, have at least one ETP CLP that is eligible for CLP Rebate.<sup>40</sup> The termination of a CLP Company, CLP Security, or ETP CLP does not preclude the Exchange from allowing re-entry into the Program where the Exchange deems such re-entry as proper.<sup>41</sup>

#### Website Disclosures

The Exchange will provide notification on its website regarding the following: (i) acceptance of a CLP Company, on behalf of a CLP Security, and an ETP 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 ETP 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(ies); (iv) a statement about the Program that sets forth a general description of the

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<sup>39</sup> See proposed Interpretation and Policy .03(c)(3) to Rule 11.8.

<sup>40</sup> See proposed Interpretation and Policy .03(n)(1) to Rule 11.8.

<sup>41</sup> See proposed Interpretation and Policy .03(n)(2) to Rule 11.8.

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 ETP CLP 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 ETP CLP to withdraw from the Program, and the date of actual withdrawal or termination from the Program.<sup>42</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>43</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>44</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>45</sup>

#### CLP Company Fees

A CLP Company participating in the Program shall incur an annual basic CLP Fee of \$10,000 per CLP Security. The basic CLP Fee must be paid to the Exchange prospectively on a

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<sup>42</sup> See proposed Interpretation and Policy .03(o) to Rule 11.8.

<sup>43</sup> See proposed Interpretation and Policy .03(d)(4) to Rule 11.8.

<sup>44</sup> Id.

<sup>45</sup> Id.

quarterly basis.<sup>46</sup>

A CLP Company may also incur an annual supplemental CLP Fee per CLP Security. The basic CLP Fee and supplemental CLP Fee, when combined, may not exceed \$100,000 per year. The supplemental CLP Fee is a fee selected by a CLP Company on an annual basis, if at all. The supplemental CLP Fee must be paid to the Exchange prospectively on a quarterly basis. The amount of the supplemental CLP Fee, if any, will be determined by the CLP Company initially per CLP Security and will remain the same for the period of a year. The Exchange will provide notification on its website regarding the amount, if any, of any supplemental CLP Fee determined by a CLP Company per CLP Security.<sup>47</sup>

The CLP Fee is in addition to the standard (non-CLP) Exchange listing fee applicable to the CLP Security and does not offset such standard listing fee.<sup>48</sup> For a CLP Security housed by a CLP Company that has a Sponsor or Sponsors, the CLP Fee with respect to the CLP Security shall be paid by the Sponsor or Sponsors of such CLP Security.<sup>49</sup> The Exchange will prospectively bill each CLP Company for the quarterly CLP Fee for each CLP Security.<sup>50</sup> CLP Fees (both basic and supplemental) will be credited to the BATS General Fund.<sup>51</sup>

#### ETP CLP Quoting Requirements

ETP CLPs will be subject to both a daily quoting requirement in order to be eligible to receive financial incentives and a monthly quoting requirement in order to remain qualified as an

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<sup>46</sup> See proposed Interpretation and Policy .03(d)(2)(A) to Rule 11.8.

<sup>47</sup> See proposed Interpretation and Policy .03(d)(2)(B) to Rule 11.8.

<sup>48</sup> See proposed Interpretation and Policy .03(d)(2)(C) to Rule 11.8.

<sup>49</sup> See proposed Interpretation and Policy .03(d)(2)(C)(i) to Rule 11.8. See also proposed Interpretation and Policy .03(b)(2) to Rule 11.8.

<sup>50</sup> See proposed Interpretation and Policy .03(d)(2)(D) to Rule 11.8.

<sup>51</sup> See proposed Interpretation and Policy .03(d)(2)(E) to Rule 11.8.

ETP CLP. Any ETP CLP that meets the daily quoting requirement set forth below will be eligible to receive a CLP Rebate for each day's quoting activity. An ETP CLP that does not meet the ETP CLP monthly quoting requirement is subject to the non-regulatory penalties described below.<sup>52</sup>

The Exchange will measure the performance of an ETP CLP in assigned CLP Securities by calculating Size Event Tests ("SETs") between 9:25 a.m. and 4:05 p.m. on every day on which the Exchange is open for business. The Exchange will measure each ETP CLP's quoted size, excluding odd lots, at the National Best Bid ("NBB") and National Best Offer ("NBO") at least once per second to determine SETs. The three ETP CLPs with the greatest aggregate size at the NBB at the time of each SET (a "Bid SET") will be considered to have a winning Bid SET (a "Winning Bid SET"). In the event of a tie, all ETP CLPs with the same aggregate size at the NBB will be considered to have a Winning Bid SET if there are two or less CLPs that have greater aggregate size at the NBB. Of the ETP CLPs with a Winning Bid SET for a particular Bid SET, the ETP CLPs with the greatest aggregate size at the NBB will receive three Bid SET credits ("Bid SET Credits"); the ETP CLPs with the second greatest aggregate size at the NBB will receive two Bid SET Credits; and the ETP CLPs with the third greatest aggregate size at the NBB will receive one Bid SET Credit. Separately, the three ETP CLPs with the greatest aggregate size at the NBO at the time of each SET (an "Offer SET") will be considered to have a winning Offer SET (a "Winning Offer SET"). In the event of a tie, all ETP CLPs with the same aggregate size at the NBO will be considered to have a Winning Offer SET if there are two or less CLPs that have greater aggregate size at the NBO. Of the ETP CLPs with a Winning Offer SET for a particular Offer SET, the ETP CLPs with the greatest aggregate size at the NBO will

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<sup>52</sup> See proposed Interpretation and Policy .03(e) to Rule 11.8.

receive three Offer SET credits (“Offer SET Credits”); the ETP CLPs with the second greatest aggregate size at the NBO will receive two Offer SET Credits; and the ETP CLPs with the third greatest aggregate size at the NBO will receive one Offer SET Credit.<sup>53</sup>

An ETP CLP must be quoting, at a minimum, five round lots (usually 500 shares), excluding odd lots, of the CLP Security, at the NBB or NBO, respectively, at the time of a SET in order to have a Winning Bid SET or a Winning Offer SET.<sup>54</sup> In addition, in order for an ETP CLP to have a Winning Bid SET during Regular Trading Hours,<sup>55</sup> the ETP CLP must also be quoting at least a displayed round lot offer, excluding odd lots, at a price at or within 1.2% of the ETP CLP’s bid at the time of the SET.<sup>56</sup> Similarly, in order for an ETP CLP to have a Winning Offer SET during Regular Trading Hours, the ETP CLP must be quoting at least a displayed round lot offer, excluding odd lots, at a price at or within 1.2% of the ETP CLP’s offer at the time of the SET.<sup>57</sup>

In order to meet the daily quoting requirement, an ETP CLP must have Winning Bid SETs or Winning Offer SETs equal to at least 10% of the total Bid SETs or total Offer SETs, respectively, on any trading day in order to be eligible for any CLP Rebate (each such ETP CLP, an “Eligible ETP CLP”) for a CLP Security. Eligible ETP CLPs will be ranked according to the number of Bid SET Credits and Offer SET Credits each trading day, and only the Eligible ETP

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<sup>53</sup> See proposed Interpretation and Policy .03(i)(1) to Rule 11.8. In the Notice, the Exchange provided examples of how SET Credits are distributed. See Notice, supra note 3, 79 FR at 33985.

<sup>54</sup> See proposed Interpretation and Policy .03(i)(4) to Rule 11.8.

<sup>55</sup> As defined in BATS Rule 1.5(w), the term “Regular Trading Hours” means the time between 9:30 a.m. and 4:00 p.m. Eastern Time.

<sup>56</sup> See proposed Interpretation and Policy .03(i)(5) to Rule 11.8.

<sup>57</sup> Id.

CLP(s) ranked number one and the Eligible ETP CLP(s) ranked number two in each of the Bid SET Credits and Offer SET Credits will receive the CLP Rebate.<sup>58</sup>

In order to meet the monthly quoting requirements, an ETP CLP must be quoting at the NBB or the NBO 10% of the time that the Exchange calculates SETs.<sup>59</sup>

For purposes of calculating whether an ETP CLP is in compliance with its ETP CLP quoting requirements, the ETP CLP must post displayed liquidity in round lots in its assigned CLP Securities at the NBB or the NBO.<sup>60</sup> An ETP CLP may post non-displayed liquidity; however, such liquidity will not be counted as credit towards the ETP CLP quoting requirements.<sup>61</sup> The ETP CLP shall not be subject to any minimum or maximum quoting size requirement in assigned CLP Securities (other than requirements relating to Winning SETs as described above) apart from the requirement that an order be for at least one round lot.<sup>62</sup> The ETP CLP quoting requirements will be measured by utilizing the unique identifiers that the Member has identified for ETP CLP trading activity.<sup>63</sup>

ETP CLPs may only enter orders electronically directly into Exchange systems and facilities designated for this purpose and all ETP CLP orders must only be for the proprietary account of the CLP Member.<sup>64</sup>

#### CLP Rebate

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<sup>58</sup> See proposed Interpretation and Policy .03(i)(1)(A) to Rule 11.8.

<sup>59</sup> See proposed Interpretation and Policy .03(i)(1)(B) to Rule 11.8.

<sup>60</sup> See proposed Interpretation and Policy .03(i)(2) to Rule 11.8.

<sup>61</sup> See proposed Interpretation and Policy .03(i)(3) to Rule 11.8.

<sup>62</sup> See proposed Interpretation and Policy .03(i)(4) to Rule 11.8.

<sup>63</sup> Id.

<sup>64</sup> See proposed Interpretation and Policy .03(k) to Rule 11.8.

As described above, pursuant to the Program, the Exchange will measure the performance of ETP CLPs in CLP Securities by calculating SETs between 9:25 a.m. and 4:05 p.m. on every day on which the Exchange is open for business. The amount of the total daily CLP Rebate available will be equal to one quarter of the total annual CLP Fees (basic and supplemental combined) for the CLP Security divided by the number of trading days in the current quarter.<sup>65</sup>

The Eligible CLPs with the highest and second highest number of Bid SET Credits will receive 60% and 40%, respectively, of half of the daily CLP Rebate for the CLP Security.<sup>66</sup> Similarly, the Eligible CLPs with the highest and second highest number of Offer SET Credits will receive 60% and 40%, respectively, of half of the daily CLP Rebate for the CLP Security.<sup>67</sup> In the event that there is only one Eligible ETP CLP for the bid or offer portion of the CLP Rebate for a CLP Security, such Eligible ETP CLP will receive 100% of such rebate.<sup>68</sup> In the event that multiple Eligible ETP CLPs have an equal number of Bid SET Credits or Offer SET Credits, the Eligible ETP CLP with the highest executed volume in the CLP Security will be awarded the greater portion of the CLP Rebate.<sup>69</sup> Where no ETP CLPs are eligible for the bid or

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<sup>65</sup> See proposed Interpretation and Policy .03(m)(1) to Rule 11.8. In the Notice, the Exchange provides the following example: 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  $((\$64,000/4)/64)$ . See Notice, supra note 3, 79 FR at 33986.

<sup>66</sup> See proposed Interpretation and Policy .03(m)(1) to Rule 11.8.

<sup>67</sup> Id.

<sup>68</sup> Id.

<sup>69</sup> Id. Specifically, if the tie is for the most Bid (Offer) SET Credits, the Eligible ETP CLP with the highest executed volume in the CLP Security will receive 60% of the applicable portion of the CLP Rebate and the Eligible ETP CLP with the second highest executed volume in the CLP Security will receive 40% and no other Eligible ETP CLPs will receive any portion of the CLP Rebate. Similarly, where the tie is for the second most

offer portion of the CLP Rebate, no CLP Rebate will be awarded to any ETP CLP and no refund will be provided to the applicable CLP Company or its Sponsor.<sup>70</sup>

#### Non-Regulatory Penalties

If an ETP CLP fails to meet the ETP CLP quoting requirements, the Exchange may impose certain non-regulatory penalties on the ETP CLP. First, if, between 9:25 a.m. and 4:05 p.m. on any day on which the Exchange is open for business, an ETP CLP fails to meet its daily quoting requirement by failing to have at least 10% of the Winning Bid SETs or Winning Offer SETs for that trading day, the ETP CLP will not be eligible to receive a CLP Rebate for that day's quoting activity in that particular assigned CLP Security.<sup>71</sup> Second, if an ETP CLP fails to meet its monthly quoting requirement for three consecutive months in any assigned CLP Security, the ETP CLP will be at risk of losing its ETP CLP status, and the Exchange may, in its discretion, take the following non-regulatory actions: (i) revoke the assignment of the affected CLP Security(ies) and/or one or more additional unaffected CLP Securities; or (ii) disqualify a Member's status as an ETP CLP.<sup>72</sup>

The Exchange shall determine if and when a Member is disqualified from its status as an ETP CLP.<sup>73</sup> One calendar month prior to any such determination, the Exchange will notify the

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Bid (Offer) SET Credits, the Eligible ETP CLP with the highest executed volume in the CLP Security will receive 40% of the of the applicable portion of the CLP Rebate and no other Eligible CLPs with equal or less Bid (Offer) SET Credits will receive any portion of the CLP Rebate. See Notice, supra note 3, 79 FR at 33986.

<sup>70</sup> See proposed Interpretation and Policy .03(m)(1) to Rule 11.8.

<sup>71</sup> See proposed Interpretation and Policy .03(l)(1)(A) to Rule 11.8.

<sup>72</sup> See proposed Interpretation and Policy .03(l)(1)(B) to Rule 11.8.

<sup>73</sup> See proposed Interpretation and Policy .03(l)(2) to Rule 11.8.



ETP CLP of such impending disqualification in writing.<sup>74</sup> If the ETP CLP fails to meet the monthly quoting requirements as described above for a third consecutive month in a particular CLP Security, the ETP CLP may be disqualified from ETP CLP status.<sup>75</sup> When disqualification determinations are made, the Exchange will provide a disqualification notice to the Member informing such Member that it has been disqualified as an ETP CLP.<sup>76</sup> In the event a Member is disqualified from its status as an ETP CLP, such Member may re-apply for ETP CLP status in accordance with the proposed rules, and such application process shall occur at least three calendar months following the month in which such Member received its disqualification notice.<sup>77</sup> Further, in the event a Member is determined to be ineligible for the CLP Rebate for failure to meet its daily quoting obligation or is disqualified from its status as an ETP CLP, such Member may seek review under Chapter X of the Exchange's Rules governing adverse action.<sup>78</sup>

#### Program Implementation on a Pilot Basis

The Exchange proposes that the Commission approve the Program for a pilot period of one year from the date of implementation, which shall occur no later than 90 days after Commission approval of the proposal (the date of which will be circulated in a notice from BATS Trade Desk).<sup>79</sup> During the pilot, the Exchange will periodically provide information to the Commission about market quality with respect to the Program. During the pilot, the Exchange will submit monthly reports to the Commission about market quality with respect to

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<sup>74</sup>

Id.

<sup>75</sup>

Id.

<sup>76</sup>

Id.

<sup>77</sup>

See proposed Interpretation and Policy .03(1)(3) to Rule 11.8.

<sup>78</sup>

Id.

<sup>79</sup>

See Notice, supra note 3, 79 FR at 33982.

the Program, which reports will endeavor to compare, to the extent practicable, securities before and after they are in the Program, including those securities that “graduate” from the Program or, where no securities have “graduated” from the Program, securities that have “graduated” from comparable programs at other exchanges to the extent that such securities exist.<sup>80</sup> Such monthly reports will include information regarding the Program which will enable the Exchange, the Commission, and the public to better analyze the effectiveness of the Program, such as: (i) Rule 605 metrics;<sup>81</sup> (ii) volume metrics; (iii) number of CLPs in target securities; (iv) spread size; and (v) availability of shares at the NBBO.<sup>82</sup> The Exchange states that it will endeavor to provide similar data to the Commission about comparable ETPs that are listed on the Exchange that are not in the Program, and any other Program-related data requested by the Commission for the purpose of evaluating the efficacy of the Program.<sup>83</sup> The Exchange will post the monthly reports on its website, and the first report will be submitted within sixty days after the Program becomes operative.<sup>84</sup>

### Surveillance

The Exchange states that its surveillance procedures are adequate to properly monitor the trading of all securities trading on the Exchange, including ETPs participating in the Program, during all trading sessions, and to detect and deter violations of Exchange rules and applicable federal securities laws.<sup>85</sup> The Exchange states that it may obtain information via the Intermarket

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<sup>80</sup> Id. at 33982-3.

<sup>81</sup> 17 CFR 242.605.

<sup>82</sup> See Notice, supra note 3, 79 FR at 33983.

<sup>83</sup> Id.

<sup>84</sup> Id.

<sup>85</sup> Id. at 33987.

Surveillance Group (“ISG”) from other exchanges who are members or affiliates of the ISG or with which the Exchange has entered into a comprehensive surveillance sharing agreement, and from listed CLP Companies and public and non-public data sources such as, for example, Bloomberg.<sup>86</sup>

Changes to Interpretation and Policy .02 to Rule 11.8

The Exchange is also proposing to make certain changes to paragraph (d)(2) of Interpretation and Policy .02 to Rule 11.8, which governs ETP participation in the existing CLP Program. The Exchange states that these changes are designed to create a “sunset” period for any ETPs that are currently participating in the CLP Program pursuant to Interpretation and Policy .02 to Rule 11.8.<sup>87</sup> Specifically, the proposed rule change will allow any ETP listed on the Exchange prior to the implementation of Rule 11.8(e), which governs the Exchange’s Lead Market Maker Program,<sup>88</sup> that is participating in the CLP Program to continue to participate in the CLP Program until the first of the following to occur: (i) such security has had a CADV of equal to or greater than two million shares for two consecutive calendar months during the first three years the security is subject to the CLP Program, provided, however, that any ETP initially listed on the Exchange shall be eligible for the CLP Program for the first six months that it is listed on the Exchange, regardless of the ETP’s CADV; (ii) such security has been subject to the CLP Program for three years; or (3) December 31, 2014.<sup>89</sup> Thus, all ETPs participating in the

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<sup>86</sup>

Id.

<sup>87</sup>

Id.

<sup>88</sup>

See Securities Exchange Act Release No. 72020 (April 25, 2014), 79 FR 24807 (May 1, 2014) (SR–BATS–2014–015). The Lead Market Maker Program was implemented on June 2, 2014. See Notice, supra note 3, 79 FR at 33982.

<sup>89</sup>

See proposed Interpretation and Policy .02(d)(2) to Rule 11.8.

CLP Program would no longer be eligible to participate in such program after December 31, 2014.

## II. Discussion and Commission Findings

The Commission has carefully considered the proposed rule change and finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to national securities exchanges. In particular, as discussed below, the Commission finds that the proposed rule change is consistent with Section 6(b)(4) of the Act,<sup>90</sup> which requires that the rules of a national securities exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities, and with Section 6(b)(5) of the Act,<sup>91</sup> which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest, and that the rules not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Further, as required by Section 3(f) of the Act, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation.<sup>92</sup>

The Program, as proposed to be implemented on a pilot basis, is designed to enhance the market quality for certain lower volume ETPs participating in the Program by incentivizing Market Makers to take ETP CLP assignments in such ETPs by offering an alternative fee structure for such ETP CLPs. As proposed by the Exchange, each ETP CLP must comply with a

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<sup>90</sup> 15 U.S.C. 78f(b)(4).

<sup>91</sup> 15 U.S.C. 78f(b)(5).

<sup>92</sup> See 15 U.S.C. 78c(f).

monthly quoting requirement in order to remain qualified as an ETP CLP, and must comply with a daily quoting requirement in order to be eligible for the daily CLP Rebates, which are higher than the standard quoting requirements applicable to Market Makers on the Exchange.<sup>93</sup> Specifically, with respect to the daily quoting requirement, the three ETP CLPs with the greatest aggregate size at the NBB or NBO at each SET will be considered to have a Winning Bid (Offer) SET, provided each ETP CLP is quoting at least 500 shares of the ETP at the NBB (NBO) and quoting at least 100 shares on the other side of the market at a price at or within 1.2% of such ETP CLP's best bid (offer). The ETP CLPs with a Winning Bid (Offer) SET for a particular Bid (Offer) SET will each receive an amount of Bid (Offer) Set Credits that is based upon each ETP CLP's quoted aggregate size at the NBB (NBO). The ETP CLPs with the highest and second highest number of Bid (Offer) SET Credits each day will receive a portion of the daily CLP Rebate, provided that such ETP CLPs have Winning Bid (Offer) SETs equal to at least 10% of the total Bid (Offer) SETs on any trading day. With respect to the monthly quoting requirement, an ETP CLP must be quoting at least 100 shares at the NBB or NBO at least 10% of the time that the Exchange is calculating Bid (Offer) SETs. Thus, the proposal is designed to incentivize both quoting frequency at the NBBO and quoted size at the NBBO, by conditioning eligibility for ETP CLP status, eligibility for the daily CLP Rebate, and allocation of the daily CLP Rebate on whether an ETP CLP meets or exceeds various quoting requirements. In addition, the Program is separately designed to incentivize ETP CLPs to compete with each other to receive the CLP Rebates, as only the eligible ETP CLPs with the highest and second highest numbers of Bid (Offer) SET Credits will receive a portion of the daily CLP Rebate, and if multiple ETP CLPs

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<sup>93</sup> See BATS Rule 11.8(d) (setting forth the quoting requirements and obligations of Market Makers).

have an equal number of Bid (Offer) SET Credits, the ETP CLP with the higher executed volume in the CLP Security on the Exchange on the particular trading day will be awarded the applicable portion of the daily CLP Rebate. As a result, the proposal has the potential to improve the market quality of the ETPs that participate in the Program by encouraging ETP CLPs to provide liquidity in such ETPs consistent with the performance standards. This potential improved market quality, were it to occur, could benefit investors in the form of enhanced liquidity, narrowed spreads, and reduced transaction costs.<sup>94</sup>

In addition, because the quoted bid-ask spread in a security represents one of the main drivers of transaction costs for investors, and because high price volatility should generally deter investors from trading low-liquidity ETPs, the Program, were the potential benefits of the program to occur, should facilitate a more-efficient and less-uncertain trading environment for investors.<sup>95</sup> Furthermore, were the potential benefits of the Program to occur, improving the

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<sup>94</sup> In support of the proposal, the Exchange argues that the Program will, among other things, lower transaction costs and enhance liquidity in both ETPs and their components, making both more attractive to a broader range of investors, and that, in so doing, the Program will help companies access capital to invest and grow. See Notice, supra note 3, 79 FR at 33983. The Exchange asserts that being included in a successful ETP can provide the stocks of these companies with enhanced liquidity and exposure, enabling them to attract investors and access capital markets to fund investment and growth. See id. at 33983, n. 17 and accompanying text. As constructed, any potential benefit to operating companies from the Program could be derived from the company being included within an index or other benchmark that underlies an ETP that participates in the Program.

<sup>95</sup> Transaction costs are generally defined as the penalty that an investor pays for transacting. Transaction costs have four components: commissions; bid/ask spread; market impact; and opportunity cost. See Grinold, Kahn. Active Portfolio Management, Second Edition, Chapter 16. An increase in bid-ask spreads will inevitably increase the transaction costs of an investor. In addition, transactions in low-liquidity securities have a higher market impact when compared to other more liquid securities. See Albert Kyle's (1985) measure of market impact (Kyle's Lambda), defining an inverse relationship between volume and price impact. Therefore, the lower the volume of the ETP or stock, the higher the market impact of any transaction in that stock. This last

liquidity of certain low-volume ETPs may lead to both an overall increase in ETP trading volume and a redistribution of trading volume toward lower-volume ETPs that would not otherwise attract sufficient liquidity to successfully participate in the market.

While the Commission believes that the Program has the potential to improve market quality of the CLP Securities participating in the Program, the Commission is concerned about unintended consequences of the Program. For example, the Program could have the potential to distort market forces because the Program may act to artificially influence trading in ETPs that otherwise would not be traded. Similarly, the Commission recognizes concerns about the potential negative impact on a CLP Security participating in the Program, such as reduced liquidity and wider spreads, when a CLP Company is withdrawn or terminated from the Program. While the Commission is mindful of these concerns, the Commission believes, for the reasons described below, that certain aspects of the Program could help mitigate these concerns.

First, the proposal contains disclosure provisions that will help to alert and educate potential and existing investors in the CLP Securities participating in the Program about the Program. Specifically, the Exchange will disclose on its website the following information: (i) the names of CLP Securities and the ETP CLP(s) in each CLP Security; (ii) the dates that a CLP Company, on behalf of a CLP Security, commences participation in and withdraws or is terminated from the Program; (iii) the name of each CLP Company and the associated CLP Securities on behalf of which it is participating in the Program; (iv) the acceptance of a CLP Company, on behalf of a CLP Security, and an ETP CLP into the Program; (v) the intent of a CLP Company, on behalf of a CLP Security, or ETP CLP to withdraw from the Program, and the

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effect acts as a disincentive to trading that security. Therefore, an environment where an ETP trades more often and with a larger number of shares will reduce transaction costs both through the narrowing of spreads and lower market impact.

date of actual withdrawal or termination from the ETP CLP Program; (vi) the total number of CLP Securities that any one CLP Company may have in the ETP CLP Program; and (vii) for each CLP Security, the amount, if any, of the supplemental CLP Fee determined by a CLP Company per CLP Security that would be in addition to the fixed basic CLP Fee of \$10,000. The Exchange also will include on its website a description of the Program, as implemented on a pilot basis, including a fair and balanced summation of the potentially positive aspects of the Program, as well as the potentially negative aspects and risks that may be attendant with an ETP's participation in the Program. Furthermore, a CLP Company will be required to disclose on a product-specific website for each CLP Security that the CLP Security is participating in the Program and will be required to provide a link on that website to the Exchange's Program website. Finally, a CLP Company that, on behalf of a CLP Security, is approved to participate in the Program will be required to issue a press release to the public when a CLP Company, on behalf of a CLP security, commences or ceases participation in the Program, to post such press release on its website (or if it does not have a website, on the website of the Sponsor of the CLP Security), and to provide on its website a hyperlink to the Exchange's webpage describing the Program. This disclosure will help to inform investors and other market participants which securities are participating in the Program, which ETP CLPs are assigned to each CLP Security, the amount of CLP Fees a CLP Company will incur as a result of participating in the Program, the amount of the daily CLP Rebates that ETP CLPs may be eligible to receive from the Exchange under the Program, and the potential benefits and risks of the Program. A wide variety of ETPs are currently listed and trading today, and the Commission believes that such disclosure could be helpful for investors and other market participants to discern which ETPs listed on the Exchange are and are not subject to the Program and to make informed investment decisions



with respect to ETPs.<sup>96</sup>

Second, the Program is targeted at a subset of ETPs, namely those ETPs that are generally less liquid and which the Exchange believes might benefit most from the Program. Specifically, as proposed, ETPs that are otherwise eligible for the Program will not be eligible if they have a CADV of equal to or greater than 1,000,000 shares for three consecutive calendar months.<sup>97</sup> Likewise, the Program will terminate with respect to a particular CLP Security if the security sustains a CADV of 1,000,000 shares or more for three consecutive months.<sup>98</sup>

Finally, as proposed by the Exchange, the Program will be limited to a one-year pilot. The Commission believes that it is important to implement the Program as a pilot. Operating the Program as a pilot will allow assessment of whether the Program is in fact achieving its goal of improving the market quality of CLP Securities, prior to any proposal or determination to make the Program permanent.<sup>99</sup> In addition, approval on a pilot basis will allow the assessment, prior to any proposal or determination to make the Program permanent, of whether the Program has any unintended impact on the CLP Securities, securities not participating in the Program, or the market or market participants generally.

The Exchange has represented that during the pilot it will submit monthly reports to the

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<sup>96</sup> The concurrent exemptive relief the Commission is issuing today from Rule 102 under Regulation M concerning the Program also contains additional disclosure requirements. See Securities Exchange Act Release No. 72693 (Jul. 28, 2014), supra note 4.

<sup>97</sup> However, any CLP Security initially listed on the Exchange will remain eligible for the Program for the first six months that it is listed on the Exchange, regardless of the ETP's CADV.

<sup>98</sup> The same exception applies to the termination provision. See supra note 97.

<sup>99</sup> The Exchange would be required to file with the Commission any proposal to extend the Program beyond the pilot period or to make the Program permanent pursuant to Section 19(b) of the Exchange Act and the rules and regulations thereunder. Such a filing would be published for comment in the Federal Register pursuant to Section 19(b) and Rule 19b-4.

Commission about market quality in respect of the Program and that these reports will be posted on the Exchange’s public website. The Exchange has represented that such reports will compare securities before and after they are in the Program, and will include information regarding CLP Security volume metrics, the number of ETP CLPs in CLP Securities, quotation spread and size statistics, and data and analysis about the market quality of CLP Securities that exceed the one million CADV threshold and “graduate” from the Program (or, where no securities have “graduated” from the Program, securities that have “graduated” from comparable programs at other exchanges to the extent that such securities exist). The Exchange also has represented that it will provide to the Commission similar data and analyses about comparable ETPs listed on the Exchange that are not participating in the Program, as well as any other Program-related data and analyses the Commission staff requests from the Exchange for the purpose of evaluating the efficacy of the Program. The Commission expects that this data and analyses provided by the Exchange should help the Commission, the Exchange, and other interested members of the public to evaluate whether the Program has resulted in the intended benefits it is designed to achieve, any unintended consequences resulting from the Program, and the extent to which the Program alleviates or aggravates the concerns the Commission has noted, including previously-stated Commission concerns relating to issuer payments to market makers.<sup>100</sup>

For example, the Exchange and the Commission will look to assess what impact, if any, there is on the market quality of CLP Securities that are withdrawn or are otherwise terminated from the Program. One way for a CLP Security to be terminated from the Program is if it exceeds the 1,000,000 CADV threshold included within the rules. The Commission recognizes that the Program may not, in the one-year pilot period, produce sufficient data (i.e., a large

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<sup>100</sup> See infra notes 102-105 and accompanying text.

number of CLP Securities that enter and exit the Program) to allow a full assessment of whether termination (or withdrawal) of a CLP Security from the Program has resulted in any unintended consequences on the market quality of the CLP Security or otherwise. However, the Commission believes that the proposal strikes a reasonable balance between (i) setting the threshold for “graduation” from the Program high enough to encourage participation in the Program and (ii) setting the threshold low enough to have a sufficient number of CLP Securities graduate from the Program within the pilot period so that the Exchange, the Commission, and other interested persons can assess the impact, if any, of the Program, including “graduation” of CLP Securities from the Program. The Commission also notes that if no securities “graduate” from the Program during the pilot period, the Exchange has represented that it will provide data and analysis to the Commission relating to securities that have “graduated” from comparable programs at other exchanges to the extent that such securities exist.

Furthermore, the pilot structure of the Program has the potential to generate data that is useful in evaluating the transition of ETPs from the existing CLP Program to the Program. The validity of inference and conclusions from statistical analysis of the pilot data may be limited by the pilot’s small scale, however.

The Commission believes that the design of the Program and the public disclosure requirements, coupled with implementation of the proposal on a pilot basis, should help mitigate potential concerns the Commission has noted above relating to any unintended or negative effects of the Program on the ETP market and investors.

The Commission has previously expressed concerns relating to payments by issuers to market makers. FINRA Rule 5250 (formerly NASD Rule 2460) prohibits FINRA members and their associated persons from directly or indirectly accepting any payment from an issuer for

acting as a market maker.<sup>101</sup> FINRA Rule 5250 was implemented, in part, to address concerns about issuers paying market makers, directly or indirectly, to improperly influence the price of an issuer's stock and because of conflict of interest concerns between issuers and market makers.<sup>102</sup>

FINRA Rule 5250 was designed to preserve “the integrity of the marketplace by ensuring that quotations accurately reflect a broker-dealer’s interest in buying or selling a security.”<sup>103</sup>

Specifically, in the NASD Rule 2460 Approval Order, the Commission found that the

“decision by a firm to make a market in a given security and the question of price generally are dependent on a number of factors, including, among others, supply and demand, the firm’s expectations toward the market, its current inventory position, and exposure to risk and competition. This decision should not be influenced by payments to the member from issuers or promoters. Public investors expect broker-dealers’ quotations to be based on the factors described above. If payments to broker-dealers by promoters and issuers were permitted, investors would not be able to ascertain which quotations in the marketplace are based on actual interest and which quotations are supported by issuers or promoters. This structure would harm investor confidence in the overall integrity of the marketplace.”<sup>104</sup>

The Commission also added that “such payments may be viewed as a conflict of interest since

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<sup>101</sup> FINRA has amended Rule 5250 to create an exception for payments to members that are expressly provided for under the rules of a national securities exchange that are effective after being filed with, or filed with and approved by, the Commission pursuant to the requirements of the Act. See Securities Exchange Act Release No. 69398 (Apr. 18, 2013), 78 FR 24261 (Apr. 24, 2013). This amendment to FINRA Rule 5250 became effective May 15, 2013.

<sup>102</sup> See Securities Exchange Act Release No. 38812 (July 3, 1997), 62 FR 37105 (July 10, 1997) (SR-NASD-97-29) (“NASD Rule 2460 Approval Order”), at 37107.

<sup>103</sup> See id. at 37107.

<sup>104</sup> See id.

they may influence the member's decision as to whether to quote or make a market in a security and, thereafter, the prices that the member would quote."<sup>105</sup>

The Commission believes that a number of aspects of the Program mitigate the concerns that FINRA Rule 5250 was designed to address. First, the Commission believes that the terms of the Program are generally objective, clear, and transparent. The standards for the Program are set forth in proposed Interpretation and Policy .03 to Rule 11.8. (further described above)<sup>106</sup> and set forth the application and withdrawal process, the CLP Company eligibility requirements, the ETP CLP qualification requirements, the fee and rebate structure, the market quality standards that an ETP CLP must meet and maintain to secure a portion of the daily CLP Rebate and maintain eligibility as an ETP CLP, the termination process, and the disclosure requirements. These requirements apply to all CLP Securities, CLP Companies, and ETP CLPs participating in the Program.

Second, the Exchange also will provide notification on its public website regarding the various aspects of the Program. As discussed above, this disclosure will include: (i) the CLP Securities and associated CLP Companies participating in the Program and the ETP CLPs assigned to each CLP Security; (ii) the date a particular CLP Company, on behalf of a CLP Security, begins participating or ceases participating in the Program; (iii) the acceptance of a CLP Company, on behalf of a CLP Security, and an ETP CLP into the Program; (iv) the intent of a CLP Company, on behalf of a CLP Security, or ETP CLP to withdraw from the Program, and the date of actual withdrawal or termination from the ETP CLP Program; (v) the total number of CLP Securities that any one CLP Company may have in the ETP CLP Program; (vi) the amount

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<sup>105</sup> See id. at 37106.

<sup>106</sup> See supra Section I.

of the supplemental CLP Fee, if any, for each CLP Security; and (v) a description of the Program, including a fair and balanced summation of the potentially positive aspects of the Program, as well as the potentially negative aspects and risks of the Program.

In addition, a CLP Company will be required to: (i) disclose on a product-specific website for each CLP Security that the CLP Security is participating in the Program and provide on its website a hyperlink to the Exchange's webpage describing the Program; and (ii) issue a press release when the CLP Company, on behalf of a CLP security, commences or ceases participation in the Program and post such press release on its website (or if it does not have a website, on the website of the Sponsor of the CLP Security).

And third, CLP Securities will be traded on the Exchange, which is a regulated market, pursuant to the current trading and reporting rules of the Exchange, and pursuant to the Exchange's established market surveillance and trade monitoring procedures. The Exchange will administer the application and acceptance of the CLP Companies and ETP CLPs into the Program, as well as the continuation in and withdrawal from the Program. The Exchange will collect the CLP Fees from CLP Companies and/or Sponsors and credit them to the Exchange's General Fund. An ETP CLP will be eligible to receive a CLP Rebate from the Exchange's General Fund only after it meets the proposed ETP CLP quoting requirements, as determined by the Exchange. Furthermore, the CLP Fees will be paid into the Exchange's General Fund, and the CLP Rebates will be paid out of the Exchange's General Fund. If no ETP CLP is eligible for the bid or offer portion of the CLP Rebate for a particular CLP Security on a particular day, no CLP Rebate will be awarded to any ETP CLP on that day and no refund will be provided to the applicable CLP Company or its Sponsor. The Commission believes that these factors, taken together, should help to mitigate the conflict of interest and other concerns that the Commission

has previously identified<sup>107</sup> relating to issuers paying for market making.

The Commission believes that it is reasonable and consistent with the Act for the Exchange to limit the Program to certain types of securities to allow the Exchange, through a pilot, to assess whether the Program will have the desired effect of improving the market quality of these securities before implementing the Program on a permanent basis. The Commission believes that it is reasonable and consistent with the Act for the Exchange to limit the Program to products under the 1,000,000 CADV threshold, to support the Exchange's stated purpose to "encourage narrow spreads and liquid markets in securities that generally have not been, or may not be, conducive to naturally having such narrow spreads and liquidity."<sup>108</sup>

The Commission believes that the CLP Fees are an equitable allocation of reasonable fees. First, participation in the Program is voluntary. An entity is free to determine whether it would be economically desirable to pay the CLP Fee, given the amount of the fee, the trading characteristics of the ETP, and the anticipated benefit. If a CLP Company chooses to participate in the Program on behalf of a CLP Security, it will incur the basic CLP Fee of \$10,000, and the CLP Company will have discretion to incur the supplemental CLP Fee in an amount up to an additional \$90,000. The CLP Fee will be paid for by the CLP Company that has a CLP Security participating in the Program or, for a CLP Security housed by a CLP Company that has a Sponsor, by the Sponsor associated with such CLP Company. Thus, the CLP Fee will be incurred and paid for by an entity that has chosen to participate in, and that may potentially

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<sup>107</sup> See NASD Rule 2460 Approval Order, supra note 102, and supra notes 102-105. See also Securities Act Release No. 6334 (Aug. 6, 1981), 46 FR 42001 (Aug. 18, 1981), at Section IV.B (Treatment as Statutory Underwriter).

<sup>108</sup> See Notice, supra note 3, 79 FR at 33983.

benefit from, the Program.<sup>109</sup> An entity that chooses not to participate will not be required to pay any additional fee beyond the standard listing and annual fees. Further, the basic CLP Fee will be the same for any CLP Company wishing to participate in the Program.

The Commission also believes that availability of the discretionary supplemental CLP Fee is consistent with the Act. Each CLP Company participating in the Program will have the choice of whether or not to incur, as well as the exact amount (up to \$90,000) of, the supplemental CLP Fee. Not all ETPs are alike, and trading in certain products may be riskier or more costly than trading in others. The Commission believes that it is reasonable to allow each CLP Company to choose to participate in the Program and to determine whether (and if so, at what amount) it is desirable to incentivize ETP CLPs through the supplemental CLP Fee to improve the market quality of certain CLP Securities. Finally, as discussed above, the payment of the supplemental CLP Fee will be transparent to the marketplace, as this information will be disclosed on the Exchange's website.

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<sup>109</sup> Issuers of exchange-traded funds registered under the Investment Company Act of 1940 ("1940 Act") are prohibited from paying directly or indirectly for distribution of their shares (i.e., directly or indirectly financing any activity that is primarily intended to result in the sale of shares), unless such payments are made pursuant to a plan that meets the requirements of Rule 12b-1 under the 1940 Act. Although the services at issue could be primarily intended to result in the sale of fund shares, the Commission has stated that such a determination will depend on the surrounding circumstances. See Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431 (June 13, 1988) ("1988 12b-1 Release"). As the Commission has noted previously, if a fund makes payments that are ostensibly for a non-distribution purpose, and the recipient of those payments finances distribution, the question arises whether the fund's assets are being used indirectly for distribution. The Commission has stated that there can be no precise definition of what types of expenditures constitute indirect use of fund assets, and this determination is based on the facts and circumstances of each individual case. In addition, fund directors, particularly independent directors bear substantial responsibility for making that judgment. See Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (October 28, 1980).



Section 11(d)(1) of the Exchange Act

Section 11(d)(1) of the Exchange Act<sup>110</sup> generally prohibits a broker-dealer from extending or maintaining credit, or arranging for the extension or maintenance of credit, on shares of new issue securities, if the broker-dealer participated in the distribution of the new issue securities within the preceding 30 days. The Commission’s view is that shares of open-end investment companies and unit investment trusts registered under the 1940 Act, such as ETP shares, are distributed in a continuous manner, and broker-dealers that sell such securities are therefore participating in the “distribution” of a new issue for purposes of Section 11(d)(1).<sup>111</sup>

The Division of Trading and Markets, acting under delegated authority, granted an exemption from Section 11(d)(1) and Rule 11d1-2 thereunder for broker-dealers that have entered into an agreement with an exchange-traded fund’s distributor to place orders with the distributor to purchase or redeem the exchange-traded fund’s shares (“Broker-Dealer APs”).<sup>112</sup> The SIA Exemption allows a Broker-Dealer AP to extend or maintain credit, or arrange for the extension or maintenance of credit, to or for customers on the shares of qualifying exchange-traded funds subject to the condition that neither the Broker-Dealer AP, nor any natural person associated with the Broker-Dealer AP, directly or indirectly (including through any affiliate of the Broker-Dealer AP), receives from the fund complex any payment, compensation, or other economic incentive to promote or sell the shares of the exchange-traded fund to persons outside the fund complex, other than non-cash compensation permitted under NASD Rule 2830(l)(5)(A),

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<sup>110</sup> 15 U.S.C. 78k(d)(1).

<sup>111</sup> See, e.g., Exchange Act Release Nos. 6726 (Feb. 8, 1962), 27 FR 1415 (Feb. 15, 1962) and 21577 (Dec. 18, 1984), 49 FR 50174 (Dec. 27, 1984).

<sup>112</sup> See Letter from Catherine McGuire, Chief Counsel, Division of Trading and Markets, Securities and Exchange Commission to Securities Industry Association (Nov. 21, 2005) (“SIA Exemption”).

(B), or (C). This condition is intended to eliminate special incentives that Broker-Dealer APs and their associated persons might otherwise have to “push” exchange-traded fund shares.<sup>113</sup>

The Program will permit certain ETPs to voluntarily incur increased listing fees payable to the Exchange. In turn, the Exchange will use the fees to make CLP Rebates to market makers that improve the liquidity of participating issuers’ securities, and thus enhance the market quality for the participating issuers. CLP Rebates will be accrued for, among other things, maintaining continuous, two-sided displayed quotes or orders. Receipt of the CLP Rebates by certain broker-dealers will implicate the conditions of the SIA Exemption<sup>114</sup> from the new issue lending restriction in Section 11(d)(1) of the Exchange Act discussed above. The Commission’s view is that the CLP Rebates market makers will receive under the proposal are indirect payments from the fund complex to the market maker and that those payments are compensation to promote the shares of the ETP. Therefore, a market maker that is also a broker-dealer receiving the incentives will not be able to rely on the SIA Exemption from Section 11(d)(1).<sup>115</sup> This does not mean that broker-dealers cannot participate in the Program; it merely means they cannot rely on

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<sup>113</sup> Trading and markets staff provided no-action relief from Section 11(d)(1) for broker-dealers engaging in secondary market proprietary or customer transactions in securities of Commodity-based Exchange-Traded Trusts (“CBETTs”) similar to the Commission’s SIA Exemption. This relief is conditioned on the broker-dealer and any natural person associated with the broker-dealer not receiving from the Fund complex, directly or indirectly, any payment, compensation or other economic incentive to promote or sell Shares to persons outside of the Fund complex, other than non-cash compensation permitted under NASD Rule 2830(1)(5)(A), (B), or (C). See No-Action Letter re: DB Commodity Index Tracking Fund and DB Commodity Services LLC (Jan. 19, 2006); No-Action Letter re: Rydex Specialized Products LLC (Dec. 5, 2005); No-Action Letter re: streetTRACKS Gold Trust (Dec. 12, 2005); and No-Action Letter re: iShares COMEX Gold Trust (Dec. 12, 2005).

<sup>114</sup> See also note 113, supra.

<sup>115</sup> Id.

the SIA Exemption<sup>116</sup> while doing so. Thus, broker-dealers that participate in the Program will need to comply with Section 11(d)(1) unless there is another applicable exemption.

III. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>117</sup> that the proposed rule change (SR-BATS-2014-022), be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>118</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>116</sup> Id.

<sup>117</sup> 15 U.S.C. 78s(b)(2).

<sup>118</sup> 17 CFR 200.30-3(a)(12).