

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-58375; File No. 10-182]

### In the Matter of the Application of BATS Exchange, Inc. for Registration as a National Securities Exchange; Findings, Opinion, and Order of the Commission

August 18, 2008.

#### I. Introduction

On November 8, 2007, BATS Exchange, Inc. ("BATS Exchange" or "Exchange") submitted to the Securities and Exchange Commission ("Commission") a Form 1 application ("Form 1") under the Securities Exchange Act of 1934 ("Act"), seeking registration as a national securities exchange pursuant to Section 6 of the Act.<sup>1</sup> On February 13, 2008, BATS Exchange submitted Amendment No. 1 to its Form 1. Notice of the application, as amended, was published for comment in the **Federal Register** on February 20, 2008.<sup>2</sup> The Commission received one comment letter regarding the BATS Exchange Form 1.<sup>3</sup> On June 18, 2008, BATS Exchange filed Amendment No. 2 to its Form 1.<sup>4</sup>

<sup>1</sup> 15 U.S.C. 78f.

<sup>2</sup> See Securities Exchange Act Release No. 57322 (February 13, 2008), 73 FR 9370 ("Notice").

<sup>3</sup> The commenter expressed support for the BATS Exchange Form 1. See letter from Brian McPartlin dated February 14, 2008.

<sup>4</sup> In Amendment No. 2, BATS Exchange modified its application by: (1) Updating its response to the Form 1 Exhibits to reflect, among other things, certain personnel changes, the existence of a new affiliate, BATS Trading Limited, audited financials for BATS Trading, Inc. ("BATS Trading"), and how BATS Exchange intends to fulfill its regulatory obligations; (2) adding a provision to the BATS Exchange Amended and Restated By-Laws that allows the stockholder of BATS Exchange to appoint the initial Member Representative Directors to the BATS Exchange Board, and amending the definition of "Executive Representative" of a member of BATS Exchange; (3) updating certain provisions of the Investors Rights Agreement; and (4) amending the BATS Holdings Amended and Restated Certificate of Incorporation to reduce the number of authorized shares of stock of BATS Holdings, Inc. ("BATS Holdings"). BATS Exchange also made certain modifications to its proposed rules to: (1) Change the start of its pre-opening session from 9:00 a.m. to 8:00 a.m.; (2) remove the ability of a person to submit one membership application with the Financial Industry Regulatory Authority, Inc. ("FINRA"), when applying for membership in both FINRA and BATS Exchange; (3) clarify that the requirement for eligibility for BATS Exchange membership of membership in another SRO applies for continued membership; (4) clarify that the 90-day waive-in period will begin on the date that BATS Exchange's application for registration as a national securities exchange is approved by the Commission; (5) amend the BATS Only Order type to provide that a non-displayed order would get a new timestamp when it becomes displayed; (6) add continuing education requirements for Authorized Traders that are substantially similar to those of FINRA; (7) specify

#### II. Statutory Standards

Under Sections 6(b) and 19(a) of the Act,<sup>5</sup> the Commission shall by order grant a registration as a national securities exchange if it finds that the exchange is so organized and has the capacity to carry out the purposes of the Act and can comply, and can enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulations thereunder, and the rules of the exchange.

As discussed in greater detail below, the Commission finds that BATS Exchange's application for exchange registration meets the requirements of the Act and the rules and regulations thereunder. Further, the Commission finds that the proposed rules of BATS Exchange are consistent with Section 6 of the Act in that, among other things, they are designed to: (1) Assure fair representation of an exchange's members in the selection of its directors and administration of its affairs and provide that, among other things, one or more directors shall be representative of investors and not be associated with the exchange, or with a broker or dealer; (2) prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, remove impediments to and perfect the mechanisms of a free and open market and a national market system; and (3) protect investors and the public interest. The Commission also believes that the rules of BATS Exchange are consistent with Section 11A of the Act.<sup>6</sup> Finally, the Commission finds that the proposed rules of BATS Exchange do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.<sup>7</sup>

certain BATS Exchange rules and recommended fine amounts for minor rule violations; (8) delete a provision requiring non-clearing members to implement certain procedures of FINRA's Code of Practice; (9) amend its rule relating to failures to deliver/receive to conform to Regulation SHO; and (10) adding a rule to codify the ability of BATS Exchange to enter into an agreement with another self-regulatory organization ("SRO") to provide regulatory services to BATS Exchange. The changes proposed in Amendment No. 2 either are not material or are otherwise responsive to the concerns of the Commission.

<sup>5</sup> 15 U.S.C. 78f(b) and 78s(a).

<sup>6</sup> 15 U.S.C. 78k-1.

<sup>7</sup> 15 U.S.C. 78f(b)(8).

#### III. Discussion

##### A. Corporate Structure

BATS Exchange has applied to the Commission to register as a national securities exchange. BATS Holdings, a Delaware corporation, will wholly own BATS Exchange and BATS Trading. Currently, BATS Trading, a registered broker-dealer, operates the BATS ECN. Before operation of BATS Exchange as a national securities exchange, BATS Trading will transfer most of its assets to BATS Exchange. BATS Trading will continue as a broker-dealer with the sole function of providing outbound order routing services to BATS Exchange.<sup>8</sup>

##### 1. Self-Regulatory Function of BATS Exchange; Relationship Between BATS Holdings, Inc. and BATS Exchange; Jurisdiction Over BATS Holdings, Inc.

Although BATS Holdings will not itself carry out regulatory functions, its activities with respect to the operation of BATS Exchange must be consistent with, and not interfere with, the Exchange's self-regulatory obligations. The proposed BATS Holdings corporate documents include certain provisions that are designed to maintain the independence of the Exchange's self-regulatory function from BATS Holdings, enable the Exchange to operate in a manner that complies with the federal securities laws, including the objectives of Sections 6(b) and 19(g) of the Act, and facilitate the ability of the Exchange and the Commission to fulfill their regulatory and oversight obligations under the Act.<sup>9</sup>

For example, BATS Holdings submits to the Commission's jurisdiction with respect to activities relating to BATS Exchange,<sup>10</sup> and agrees to provide the Commission and BATS Exchange with access to its books and records that are related to the operation or administration of BATS Exchange.<sup>11</sup> In addition, to the extent they are related to the operation or administration of BATS Exchange, the books, records, premises, officers, directors, agents, and employees of BATS Holdings shall be deemed the books, records, premises, officers, directors, agents, and employees of BATS Exchange for purposes of, and subject to oversight pursuant to, the Act.<sup>12</sup> BATS Holdings

<sup>8</sup> See BATS Exchange Rule 2.11. See also *infra* note 151 and accompanying text.

<sup>9</sup> See BATS Holdings Amended and Restated By-Laws Article XII and Article XIV, Sections 14.01, 14.02, 14.03, 14.04, 14.05, and 14.06.

<sup>10</sup> See BATS Holdings Amended and Restated By-Laws Article XIV, Section 14.05.

<sup>11</sup> See BATS Holdings Amended and Restated By-Laws Article XIV, Section 14.03.

<sup>12</sup> *Id.*

also agrees to keep confidential non-public information relating to the self-regulatory function<sup>13</sup> of BATS Exchange and not to use such information for any non-regulatory purpose.<sup>14</sup> In addition, the board of directors of BATS Holdings, as well as its officers, employees, and agents, are required to give due regard to the preservation of the independence of the Exchange's self-regulatory function.<sup>15</sup> Further, BATS Holdings By-Laws require that any changes to the BATS Holdings Certificate of Incorporation and By-Laws be submitted to the Board of Directors of the Exchange ("Exchange Board"), and, if such amendment is required to be filed with the Commission pursuant to Section 19(b) of the Act, such change shall not be effective until filed with, or filed with and approved by, the Commission.<sup>16</sup> The Commission finds that these provisions are consistent with the Act, and that they will assist the Exchange in fulfilling its self-regulatory obligations and in administering and complying with the requirements of the Act.

The Commission also believes that under Section 20(a) of the Act<sup>17</sup> any person with a controlling interest in BATS Exchange would be jointly and severally liable with and to the same extent that BATS Exchange is liable under any provision of the Act, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. In addition, Section 20(e) of the Act<sup>18</sup> creates aiding and abetting liability for any person who knowingly provides substantial assistance to another person in violation of any provision of the Act or rule thereunder. Further, Section 21C of the Act<sup>19</sup> authorizes the Commission to enter a cease-and-desist order against any person who has been "a cause of" a violation of any provision of the Act through an act or omission that the person knew or should have known would contribute to the violation. These

<sup>13</sup> This requirement to keep confidential non-public information relating to the self-regulatory function shall not limit the Commission's ability to access and examine such information or limit the ability of directors, officers, or employees of BATS Holdings to disclose such information to the Commission. See BATS Holdings Amended and Restated By-Laws Article XIV, Section 14.02.

<sup>14</sup> See BATS Holdings Amended and Restated By-Laws Article XIV, Section 14.02.

<sup>15</sup> See BATS Holdings Amended and Restated By-Laws Article XIV, Section 14.01.

<sup>16</sup> See BATS Holdings Amended and Restated Certificate of Incorporation TWELFTH and BATS Holdings Amended and Restated By-Laws Article XII.

<sup>17</sup> 15 U.S.C. 78t(a).

<sup>18</sup> 15 U.S.C. 78t(e).

<sup>19</sup> 15 U.S.C. 78u-3.

provisions are applicable to BATS Holdings' dealings with BATS Exchange.

## 2. Ownership and Voting Limitations; Changes in Control of BATS Exchange

The BATS Holdings proposed Amended and Restated Certificate of Incorporation includes restrictions on the ability to own and vote shares of capital stock of BATS Holdings.<sup>20</sup> These limitations are designed to prevent any shareholder from exercising undue control over the operation of BATS Exchange and to assure that the Exchange and the Commission are able to carry out their regulatory obligations under the Act.

Generally, no person, either alone or together with its related persons,<sup>21</sup> may beneficially own more than forty percent of any class of capital stock of BATS Holdings.<sup>22</sup> The BATS Holdings proposed Amended and Restated Certificate of Incorporation prohibits BATS Exchange members, either alone or together with their related persons, from beneficially owning more than twenty percent of shares of any class of capital stock of BATS Holdings.<sup>23</sup> If any stockholder violates these ownership limits, BATS Holdings will redeem the shares in excess of the applicable ownership limit for their fair market value.<sup>24</sup> In addition, no person, alone or together with its related persons, may vote or cause the voting of more than twenty percent of the voting power of the then issued and outstanding capital stock of BATS Holdings.<sup>25</sup> If any stockholder purports to vote, or cause the voting of, shares that would violate this voting limit, BATS Holdings will not honor such vote in excess of the voting limit.<sup>26</sup>

The BATS Holdings Board may waive the forty percent ownership limitation applicable to non-BATS Exchange member stockholders and the twenty

<sup>20</sup> These provisions are generally consistent with ownership and voting limits approved by the Commission for other SROs. See e.g., Securities Exchange Act Release Nos. 53963 (June 8, 2006), 71 FR 34660 (June 15, 2006) (SR-NSX-2006-03) ("NSX Demutualization Order"); 51149 (February 8, 2005), 70 FR 7531 (February 14, 2005) (SR-CHX-2004-26) ("CHX Demutualization Order"); and 49098 (January 16, 2004), 69 FR 3974 (January 27, 2004) (SR-Phlx-2003-73) ("Phlx Demutualization Order").

<sup>21</sup> See BATS Holdings Amended and Restated Certificate of Incorporation FIFTH (a)(ii).

<sup>22</sup> See BATS Holdings Amended and Restated Certificate of Incorporation FIFTH (b)(i)(A).

<sup>23</sup> See BATS Holdings Amended and Restated Certificate of Incorporation FIFTH (b)(i)(B).

<sup>24</sup> See BATS Holdings Amended and Restated Certificate of Incorporation FIFTH (e).

<sup>25</sup> See BATS Holdings Amended and Restated Certificate of Incorporation FIFTH (b)(i)(C).

<sup>26</sup> See BATS Holdings Amended and Restated Certificate of Incorporation FIFTH (d).

percent voting limitation, pursuant to a resolution duly adopted by the Board of Directors, if it makes certain findings. Any such waiver would not be effective until approved by the Commission pursuant to Section 19 of the Act.<sup>27</sup> However, as long as BATS Holdings directly or indirectly controls BATS Exchange, the BATS Holdings Board cannot waive the voting and ownership limits above twenty percent for BATS Exchange members and their related persons.<sup>28</sup>

Members that trade on an exchange traditionally have ownership interests in such exchange. As the Commission has noted in the past, however, a member's interest in an exchange could become so large as to cast doubt on whether the exchange can fairly and objectively exercise its self-regulatory responsibilities with respect to that member.<sup>29</sup> A member that is a controlling shareholder of an exchange might be tempted to exercise that controlling influence by directing the exchange to refrain from, or the exchange may hesitate to, diligently monitor and surveil the member's conduct or diligently enforce its rules and the federal securities laws with respect to conduct by the member that violates such provisions.

In addition, as proposed, BATS Exchange will be a wholly-owned subsidiary of BATS Holdings. The BATS Exchange Amended and Restated By-Laws identifies this ownership structure.<sup>30</sup> Any changes to the BATS Exchange Amended and Restated By-Laws, including any change in the provision that identifies BATS Holdings as the sole owner, must be filed with and approved by the Commission pursuant to Section 19 of the Act.<sup>31</sup> Further, pursuant to the BATS Exchange Amended and Restated By-Laws, BATS Holdings may not transfer or assign, in whole or in part, its ownership interest in BATS Exchange.<sup>32</sup>

<sup>27</sup> See BATS Holdings Amended and Restated Certificate of Incorporation FIFTH (b)(ii)(B).

<sup>28</sup> These provisions are generally consistent with waiver of ownership and voting limits approved by the Commission for other SROs. See e.g., NSX Demutualization Order, *supra* note 20; CHX Demutualization Order, *supra* note 20; and Securities Exchange Act Release No. 49718 (May 17, 2004), 69 FR 29611 (May 24, 2004) (SR-PCX-2004-08).

<sup>29</sup> See, e.g., Securities Exchange Act Release Nos. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131) ("Nasdaq Exchange Registration Order") and 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (SR-NYSE-2005-77) ("NYSE/Archipelago Merger Approval Order").

<sup>30</sup> See BATS Exchange Amended and Restated By-Laws Article I(cc).

<sup>31</sup> See 15 U.S.C. 78s.

<sup>32</sup> See BATS Exchange Amended and Restated By-Laws Article IV, Section 7.

The Commission believes that these provisions are consistent with the Act. These requirements should minimize the potential that a person could improperly interfere with or restrict the ability of the Commission or the Exchange to effectively carry out their regulatory oversight responsibilities under the Act.

### 3. BATS Exchange

BATS Exchange has applied to the Commission to register as a national securities exchange. As part of its exchange application, the Exchange has filed the BATS Exchange Certificate of Incorporation and the proposed Amended and Restated By-Laws of BATS Exchange. In these documents, among other things, BATS Exchange establishes the composition of the Exchange Board and the BATS Exchange committees.

#### a. The BATS Exchange Board of Directors

The Exchange Board will be the governing body of BATS Exchange and possess all of the powers necessary for the management of the business and affairs of the Exchange and the execution of its responsibilities as an SRO. Under the BATS Exchange Amended and Restated By-Laws:

- The Exchange Board will be composed of ten directors;<sup>33</sup>
- One director will be the Chief Executive Officer of BATS Exchange;<sup>34</sup>
- The number of Non-Industry Directors,<sup>35</sup> including at least one Independent Director,<sup>36</sup> will equal or exceed the sum of the number of Industry Directors<sup>37</sup> and Member Representative Directors;<sup>38</sup> and

<sup>33</sup> See BATS Exchange Amended and Restated By-Laws Article III, Section 2(a).

<sup>34</sup> See BATS Exchange Amended and Restated By-Laws Article III, Section 2(b).

<sup>35</sup> "Non-Industry Director" means a Director who is an Independent Director or any other individual who would not be an Industry Director. See BATS Exchange Amended and Restated By-Laws Article I(v).

<sup>36</sup> "Independent Director" means a "Director who has no material relationship with the [Exchange], or any Exchange Member or any affiliate of any such Exchange Member; provided, however, that an individual who otherwise qualifies as an Independent Director shall not be disqualified from serving in such capacity solely because such Director is a Director of the [Exchange] or its stockholder." See BATS Exchange Amended and Restated By-Laws Article I(m).

<sup>37</sup> Generally, an "Industry Director" is, among other things, a Director that is or has been within the past three years an officer, director, employee, or owner of a broker-dealer. In addition, persons who have a consulting or employment relationship with the Exchange and its affiliates, are considered "Industry." See BATS Exchange Amended and Restated By-Laws Article I(o).

<sup>38</sup> See BATS Exchange Amended and Restated By-Laws Article III, Section 2(b)(i).

- At least twenty percent of the directors on the Exchange Board will be Member Representative Directors.<sup>39</sup>

BATS Holdings will appoint the initial Exchange Board, including the Member Representative Directors, which shall serve until the first annual meeting of stockholders.<sup>40</sup> The first annual meeting of the stockholders will be held prior to BATS Exchange commencing operations as a national securities exchange.<sup>41</sup> At the first annual meeting of stockholders, a new Exchange Board will be elected pursuant to the BATS Exchange Amended and Restated By-Laws. Therefore, prior to commencing operations as a national securities exchange, BATS Exchange Members will have the opportunity to participate in the selection of Member Representative Directors, and the Exchange Board will be in compliance with the compositional requirements contained in the BATS Exchange Amended and Restated By-Laws.<sup>42</sup>

BATS Holdings will appoint the initial Nominating Committee<sup>43</sup> and Member Nominating Committee,<sup>44</sup> consistent with each committee's compositional requirements,<sup>45</sup> to nominate candidates for election to the Exchange Board. Each of the Nominating Committee and Member Nominating Committee, after completion of its respective duties for nominating directors for election to the Board for that year, shall nominate

<sup>39</sup> See BATS Exchange Amended and Restated By-Laws Article III, Section 2(b)(ii). "Member Representative Director" means a "Director who has been elected by stockholders after having been nominated by the Member Nominating Committee or by an Exchange Member pursuant to these By-Laws and confirmed as the nominee of Exchange Members after majority vote of Exchange Members, if applicable. A Member Representative Director must be an officer, director, employee, or agent of an Exchange member that is not a Stockholder Exchange Member." See BATS Exchange Amended and Restated By-Laws Article I(s). See also BATS Exchange Amended and Restated By-Laws Article III, Section 4(b).

<sup>40</sup> See BATS Exchange Amended and Restated By-Laws Article I(s) and Article III, Section 4(g); see also Amendment No. 2.

<sup>41</sup> See BATS Exchange Amended and Restated By-Laws Article IV, Section 1(b).

<sup>42</sup> See BATS Exchange Amended and Restated By-Laws Article III, Section 2.

<sup>43</sup> See BATS Exchange Amended and Restated By-Laws Article VI, Section 2. The Nominating Committee will be comprised of at least three directors, and the number of Non-Industry members on the Nominating Committee must equal or exceed the number of Industry members.

<sup>44</sup> See BATS Exchange Amended and Restated By-Laws Article VI, Section 3. The Member Nominating Committee will be comprised of at least three directors, and each member of the Member Nominating Committee shall be a Member Representative member.

<sup>45</sup> See BATS Exchange Amended and Restated By-Laws Article VI, Section 1.

candidates to serve on the succeeding year's Nominating Committee or Member Nominating Committee, as applicable. Additional candidates for the Member Nominating Committee may be nominated and elected by BATS Exchange Members pursuant to a petition process.<sup>46</sup>

The Nominating Committee will nominate candidates for each director position other than the Member Representative Directors, and BATS Holdings, as the sole shareholder, will elect those directors. The Member Nominating Committee will nominate candidates for each Member Representative Director position on the Exchange Board.<sup>47</sup> Additional candidates may be nominated for the Member Representative Director positions by BATS Exchange Members pursuant to a petition process.<sup>48</sup> If no candidates are nominated pursuant to a petition process, then the initial nominees of the Member Nominating Committee will be nominated as Member Representative Directors by the Nominating Committee. If a petition process produces additional candidates, then the candidates nominated pursuant to a petition process, together with those nominated by the Member Nominating Committee, will be presented to BATS Exchange Members for election to determine the final nomination of Member Representative Directors.<sup>49</sup> The candidates who receive the most votes will be nominated as Member Representative Directors by the Nominating Committee.<sup>50</sup> BATS Holdings, as the sole shareholder, will elect those candidates nominated by the Nominating Committee as Member Representative Directors.<sup>51</sup>

<sup>46</sup> See BATS Exchange Amended and Restated By-Laws Article VI, Section 1.

<sup>47</sup> The Member Nominating Committee will solicit comments from BATS Exchange Members for the purpose of approving and submitting names of candidates for election to the position of Member Representative Director. See BATS Exchange Amended and Restated By-Laws Article III, Section 4(b).

<sup>48</sup> See BATS Exchange Amended and Restated By-Laws Article III, Section 4(c). The petition must be signed by Executive Representatives of ten percent or more of the Exchange members. No Exchange member, together with its affiliates, may account for more than fifty percent of the signatures endorsing a particular candidate. *Id.*

<sup>49</sup> See BATS Exchange Amended and Restated By-Laws Article III, Section 4(e) and (f). Each BATS Exchange Member shall have the right to cast one vote for each available Member Representative Director nomination, provided that any such vote must be cast for a person on the List of Candidates and that no BATS Exchange Member, together with its affiliates, may account for more than twenty percent of the votes cast for a candidate. *Id.*

<sup>50</sup> See BATS Exchange Amended and Restated By-Laws Article III, Section 4(f).

<sup>51</sup> *Id.*

The Commission believes that the requirement in the BATS Exchange Amended and Restated By-Laws that twenty percent of the directors be Member Representative Directors and the means by which they are chosen by members provides for the fair representation of members in the selection of directors and the administration of BATS Exchange consistent with the requirement in Section 6(b)(3) of the Act.<sup>52</sup> As the Commission has previously noted, this requirement helps to ensure that members have a voice in the use of self-regulatory authority, and that an exchange is administered in a way that is equitable to all those who trade on its market or through its facilities.<sup>53</sup>

The Commission has previously stated its belief that the inclusion of public, non-industry representatives on exchange oversight bodies is critical to an exchange's ability to protect the public interest.<sup>54</sup> Further, public, non-industry representatives help to ensure that no single group of market participants has the ability to systematically disadvantage other market participants through the exchange governance process. The Commission believes that public directors can provide unique, unbiased perspectives, which should enhance the ability of the Exchange Board to address issues in a non-discriminatory fashion and foster the integrity of BATS Exchange.<sup>55</sup> The Commission believes that the Exchange Board satisfies the requirements in Section 6(b)(3) of the Act,<sup>56</sup> which requires that one or more directors be representative of issuers and investors and not be associated with a member of the exchange, or with a broker or dealer.<sup>57</sup>

#### b. BATS Exchange Committees

In the BATS Exchange Amended and Restated By-Laws, BATS Exchange has proposed to establish several committees. Specifically, BATS

Exchange has proposed to establish the following committees that would be appointed by the Chairman of the Exchange Board, with the approval of the Exchange Board: A Compensation Committee;<sup>58</sup> Audit Committee;<sup>59</sup> Regulatory Oversight Committee;<sup>60</sup> Appeals Committee;<sup>61</sup> Executive Committee;<sup>62</sup> and Finance Committee.<sup>63</sup> In addition, BATS Exchange has proposed to establish a Nominating Committee<sup>64</sup> and a Member Nominating Committee, which would be elected on an annual basis by vote of stockholders.<sup>65</sup> For the reasons discussed above, the Commission believes that BATS Exchange's proposed committees should enable BATS Exchange to carry out its responsibilities under the Act and are consistent with the Act.

#### B. Regulation of BATS Exchange

As a prerequisite for the Commission's approval of an exchange's application for registration, an exchange must be organized and have the capacity to carry out the purposes of the Act.<sup>66</sup> Specifically, an exchange must be able

<sup>58</sup> See BATS Exchange Amended and Restated By-Laws Article V, Section 6(a). The Compensation Committee will be comprised of at least three people, and each voting member of the Compensation Committee shall be a Non-Industry Director. *Id.*

<sup>59</sup> See BATS Exchange Amended and Restated By-Laws Article V, Section 6(b). The Audit Committee will be comprised of at least three people, and a majority of the Audit Committee members shall be Non-Industry Directors and a Non-Industry Director shall serve as Chairman of the Audit Committee. *Id.*

<sup>60</sup> See BATS Exchange Amended and Restated By-Laws Article V, Section 6(c). The Regulatory Oversight Committee will be comprised of at least three people, and each member of the Regulatory Oversight Committee shall be a Non-Industry Director. *Id.*

<sup>61</sup> See BATS Exchange Amended and Restated By-Laws Article V, Section 6(d). The Appeals Committee shall consist of one Independent Director, one Industry Director, and one Member Representative Director. *Id.*

<sup>62</sup> See BATS Exchange Amended and Restated By-Laws Article V, Section 6(e). The number of Non-Industry Directors on the Executive Committee shall equal or exceed the number of Industry Directors. The percentage of Independent Directors on the Executive Committee shall be at least as great as the percentage of Independent Directors on the whole Exchange Board, and the percentage of Member Representative Directors on the Executive Committee shall be at least as great as the percentage of Member Representative Directors on the whole Exchange Board. *Id.*

<sup>63</sup> See BATS Exchange Amended and Restated By-Laws Article V, Section 6(f).

<sup>64</sup> See BATS Exchange Amended and Restated By-Laws Article VI, Section 2, and *supra* note 43.

<sup>65</sup> See BATS Exchange Amended and Restated By-Laws Article VI, Section 1, and *supra* note 44. Additional candidates for the Member Nominating Committee may be nominated and elected by BATS Exchange members pursuant to a petition process. See *supra* note 48 and accompanying text.

<sup>66</sup> See Section 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1).

to enforce compliance by its members, and persons associated with its members, with the federal securities laws and the rules of the exchange.<sup>67</sup>

#### 1. Membership

Membership on BATS Exchange will be open to any registered broker or dealer that is a member of another registered national securities exchange or association, or any natural person associated with such a registered broker or dealer.<sup>68</sup> To remain eligible for membership in BATS Exchange, a BATS Exchange member must be a member of another SRO at all times.<sup>69</sup>

For a temporary 90-day period after approval of BATS Exchange's application, an applicant that is an active member of another SRO and is a current or former subscriber to the BATS ECN will be able to apply through an expedited process to become a BATS Exchange member, and to register with BATS Exchange all of its associated persons whose registrations are active at the time BATS Exchange is approved as a national securities exchange, by submitting a waive-in application form, including membership agreements.<sup>70</sup> BATS Exchange may request additional documentation in addition to the waive-in application form in order to determine that a waive-in applicant meets BATS Exchange's qualification standards.<sup>71</sup> All of the firm's associated persons who are registered in categories recognized by BATS Exchange rules would become registered persons of a BATS Exchange member firm.<sup>72</sup>

All other applicants (and after the 90-day period has ended, those that could have waived in through the expedited process) may apply for membership in BATS Exchange by submitting a full membership application to BATS Exchange.<sup>73</sup> Applications for association with an Exchange Member shall be submitted to the Exchange on Form U-4 and such other forms as BATS Exchange may prescribe.

BATS Exchange will receive and review all applications for membership in the Exchange. If the Exchange is satisfied that the applicant is qualified for membership, the Exchange will promptly notify the applicant, in writing, of such determination, and the applicant shall be a member of the

<sup>67</sup> *Id.* See also Section 19(g) of the Act, 15 U.S.C. 78s(g).

<sup>68</sup> See BATS Exchange Rules 2.3 and 2.5(a)(4) and Amendment No. 2.

<sup>69</sup> *Id.*

<sup>70</sup> See BATS Exchange Rule 2.4.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> See BATS Exchange Rule 2.6 and Amendment No. 2.

<sup>52</sup> 15 U.S.C. 78f(b)(3).

<sup>53</sup> See Nasdaq Exchange Registration Order and NYSE/Archipelago Merger Approval Order, *supra* note 29.

<sup>54</sup> See, e.g., Regulation of Exchanges and Alternative Trading Systems, Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Release").

<sup>55</sup> See Nasdaq Exchange Registration Order and NYSE/Archipelago Merger Approval Order, *supra* note 29.

<sup>56</sup> 15 U.S.C. 78f(b)(3).

<sup>57</sup> The number of Non-Industry Directors on the Exchange Board must equal or exceed the sum of the Industry and Member Representative Directors, and the Exchange Board must include at least one Independent Director. See BATS Exchange Amended and Restated By-Laws Article III, Section 2(b)(i).

Exchange.<sup>74</sup> If the Exchange is not satisfied that the applicant is qualified for membership, the Exchange shall promptly notify the applicant of the grounds for denial.<sup>75</sup> Once an applicant is a member of the Exchange, it must continue to possess all the qualifications set forth in the BATS Exchange rules. When the Exchange has reason to believe that an Exchange member or associated person of a member fails to meet such qualifications, the Exchange may suspend or revoke such person's membership or association.<sup>76</sup>

Appeal of a staff denial, suspension, or termination of membership will be heard by the Appeals Committee.<sup>77</sup> Decisions of the Appeals Committee will be made in writing and will be sent to the parties to the proceeding. The decisions of the Appeals Committee will be subject to review by the Exchange Board, on its own motion, or upon written request by the aggrieved party or by the Chief Regulatory Officer ("CRO"). The Exchange Board will have sole discretion to grant or deny the request. The Exchange Board will conduct the review of the Appeals Committee's decision. The Exchange Board may affirm, reverse, or modify the Appeals Committee's decision. The Exchange Board's decision is final.<sup>78</sup>

The Commission finds that the BATS Exchange's membership rules are consistent with Section 6 of the Act,<sup>79</sup> specifically Section 6(b)(2) of the Act,<sup>80</sup> which requires that a national securities exchange have rules that provide that any registered broker or dealer or natural person associated with such broker or dealer may become a member and any person may become associated with an exchange member. The Commission notes that pursuant to Section 6(c) of the Act, an exchange must deny membership to any person, other than a natural person, that is not a registered broker or dealer, any natural person that is not, or is not associated with, a registered broker or dealer, and registered broker-dealers that do not satisfy certain standards, such as financial responsibility or operational capacity. As a registered exchange, BATS Exchange must independently determine if an applicant satisfies the

standards set forth in the Act, regardless of whether an applicant is a member of another SRO.<sup>81</sup>

## 2. Regulatory Independence

BATS Exchange has proposed several measures to help ensure the independence of its regulatory function from its market operations and other commercial interests. The regulatory operations of BATS Exchange will be supervised by the CRO and monitored by the Regulatory Oversight Committee. The Regulatory Oversight Committee will consist of three members, each of whom must be a Non-Industry Director.<sup>82</sup> The Regulatory Oversight Committee will be responsible for monitoring the adequacy and effectiveness of the Exchange's regulatory program, assessing the Exchange's regulatory performance, and assisting the Exchange Board in reviewing the Exchange's regulatory plan and the overall effectiveness of the Exchange's regulatory functions.<sup>83</sup> The Regulatory Oversight Committee also will meet with the CRO in executive session at regularly scheduled meetings and at any time upon request of the CRO or any member of the Regulatory Oversight Committee.<sup>84</sup>

BATS Exchange proposes that its CRO have general supervision of the regulatory operations of the Exchange, including overseeing surveillance, examination, and enforcement functions.<sup>85</sup> The CRO also will administer any regulatory services agreement with another SRO to which BATS Exchange is a party.<sup>86</sup> The CRO will be an Executive Vice President or Senior Vice President that reports directly to the Chief Executive Officer.<sup>87</sup> The CRO also may serve as BATS Exchange's General Counsel.<sup>88</sup> In addition, any revenues received by BATS Exchange from fees derived from its regulatory function or regulatory penalties will not be used for non-regulatory purposes.<sup>89</sup>

The Commission is concerned about the potential for unfair competition and conflicts of interest between an exchange's self-regulatory obligations

and its commercial interests that could exist if an exchange were to otherwise become affiliated with one of its members, as well as the potential for unfair competitive advantage that the affiliated member could have by virtue of informational or operational advantages, or the ability to receive preferential treatment.<sup>90</sup> BATS Exchange Rule 2.10 provides that without the prior approval of the Commission, BATS Exchange or any entity with which it is affiliated shall not, directly or indirectly, acquire or maintain an ownership interest in a BATS Exchange member, and a BATS Exchange member shall not be or become an affiliate of BATS Exchange, or an affiliate of any affiliate of the Exchange.<sup>91</sup> BATS Exchange also has proposed for Commission approval BATS Exchange Rule 2.11, which provides that BATS Trading, a registered broker-dealer, will provide an Outbound Router function as a facility of the Exchange pursuant to certain conditions and limitations.<sup>92</sup> BATS Trading is an affiliate of BATS Exchange and will become a member of BATS Exchange. This affiliation would not be consistent with proposed Rule 2.10 absent prior Commission approval. As part of the approval today of BATS Exchange's application for registration as a national securities exchange, the Commission is approving BATS Exchange Rule 2.11.

The Commission believes that the Exchange's proposal is consistent with the Act, particularly with Section 6(b)(1), which requires an exchange to be so organized and have the capacity to carry out the purposes of the Act.<sup>93</sup> Although the Commission continues to be concerned about potential unfair competition and conflict of interest between an exchange's self-regulatory obligations and its commercial interests when an exchange is affiliated with one of its members, the Commission believes that it is consistent with the Act to permit BATS Trading to become an affiliate of BATS Exchange for the limited Outbound Router function, in light of the protections afforded by the conditions and limitations imposed in BATS Exchange's rules.<sup>94</sup>

<sup>81</sup> See Nasdaq Exchange Registration Order, *supra* note 29.

<sup>82</sup> See BATS Exchange Amended and Restated By-Laws Articles I(v) and V, Section 6(c).

<sup>83</sup> See BATS Exchange Amended and Restated By-Laws Article V, Section 6(c).

<sup>84</sup> See BATS Exchange Amended and Restated By-Laws Article VII, Section 9.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.* See Nasdaq Exchange Registration Order, *supra* note 29.

<sup>89</sup> See BATS Exchange Amended and Restated By-Laws Article X, Section 4.

<sup>90</sup> See, e.g., Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006).

<sup>91</sup> See BATS Exchange Rule 2.10.

<sup>92</sup> See *infra* Section III.E.

<sup>93</sup> See 15 U.S.C. 78f(b)(1).

<sup>94</sup> See *infra* Section III.E. The Commission has approved similar arrangements for other SROs. See, e.g., Securities Exchange Act Release Nos. 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008) (SR-NASDAQ-2007-004) ("NOM Approval Order") and 54391 (August 31, 2006), 71 FR 52836

<sup>74</sup> See BATS Exchange Rule 2.6(c).

<sup>75</sup> See BATS Exchange Rule 2.6(d).

<sup>76</sup> See BATS Exchange Rule 2.7; see also BATS Exchange Rules Chapters VII and VIII.

<sup>77</sup> See BATS Exchange Rule 10.3; see also BATS Exchange Amended and Restated By-Laws Article V, Section 6(d).

<sup>78</sup> See BATS Exchange Rule 10.5(b). Membership decisions are subject to review by the Commission. See BATS Exchange Rule 10.7.

<sup>79</sup> 15 U.S.C. 78f.

<sup>80</sup> 5 U.S.C. 78f(b)(2).

### 3. Regulatory Contract

Although BATS Exchange will be an SRO with all of the attendant regulatory obligations under the Act, it has entered into a regulatory contract with FINRA ("Regulatory Contract"), under which FINRA will perform certain regulatory functions on BATS Exchange's behalf.<sup>95</sup> Specifically, BATS Exchange represents that FINRA will assist Exchange staff on registration issues on an as-needed basis, investigate potential violations of BATS Exchange's rules or federal securities laws related to activity on the Exchange, conduct examinations related to market conduct on the Exchange by Members, assist the Exchange with disciplinary proceedings pursuant to BATS Exchange's Rules, including issuing charges and conducting hearings, and provide dispute resolution services to BATS Exchange Members on behalf of the Exchange, including operation of the Exchange's arbitration program. BATS Exchange represents that FINRA also will provide the Exchange with access to FINRA's WebCRD system, and will assist with programming BATS-specific functionality relating to such system.<sup>96</sup> Notwithstanding the Regulatory Contract, BATS Exchange will retain ultimate legal responsibility for the regulation of its members and its market.

The Commission believes that it is consistent with the Act to allow BATS Exchange to contract with FINRA to perform examination, enforcement, and disciplinary functions.<sup>97</sup> These functions are fundamental elements to a regulatory program, and constitute core self-regulatory functions. It is essential to the public interest and the protection of investors that these functions are carried out in an exemplary manner, and the Commission believes that FINRA has the expertise and experience to perform these functions on behalf of BATS Exchange.<sup>98</sup>

(September 7, 2006) (SR-NSX-2006-08) ("NSX Blade Approval Order").

<sup>95</sup> See BATS Exchange Rule 13.7; see also Amendment No. 2. Pursuant to the applicable provisions of the Freedom of Information Act, 5 U.S.C. 552, and Commission regulations thereunder, 17 CFR 200.83, BATS Exchange has requested confidential treatment for the Regulatory Contract.

<sup>96</sup> See Amendment No. 2.

<sup>97</sup> See, e.g., Regulation ATS Release, *supra* note 54. See also Securities Exchange Act Release 50122 (July 29, 2004), 69 FR 47962 (August 6, 2004) (SR-Amex-2004-32) (order approving rule that allowed Amex to contract with another SRO for regulatory services) ("Amex Regulatory Services Approval Order"); NOM Approval Order, *supra* note 94; and Nasdaq Exchange Registration Order, *supra* note 29.

<sup>98</sup> See Amex Regulatory Services Approval Order, *supra* note 97; NOM Approval Order, *supra* note 94; and Nasdaq Exchange Registration Order, *supra*

At the same time, BATS Exchange, unless relieved by the Commission of its responsibility,<sup>99</sup> bears the responsibility for self-regulatory conduct and primary liability for self-regulatory failures, not the SRO retained to perform regulatory functions on the Exchange's behalf. In performing these regulatory functions, however, FINRA may nonetheless bear liability for causing or aiding and abetting the failure of BATS Exchange to perform its regulatory functions.<sup>100</sup> Accordingly, although FINRA will not act on its own behalf under its SRO responsibilities in carrying out these regulatory services for BATS Exchange, FINRA may have secondary liability if, for example, the Commission finds that the contracted functions are being performed so inadequately as to cause a violation of the federal securities laws by BATS Exchange.<sup>101</sup>

Although BATS Exchange has entered into the Regulatory Contract, the provisions in the Regulatory Contract that will specify the particular BATS Exchange and Commission rules for which FINRA will provide certain regulatory functions have not been finalized. Accordingly, the Commission is conditioning the operation of BATS Exchange on the execution of the Regulatory Contract and finalization of the provisions in the Regulatory Contract that will specify the BATS Exchange and Commission rules for which FINRA will provide regulatory functions.<sup>102</sup>

### 4. 17d-2 Agreement

Section 19(g)(1) of the Act<sup>103</sup> requires every SRO to examine its members and persons associated with its members and to enforce compliance with the federal securities laws and the SRO's own rules, unless the SRO is relieved of this responsibility pursuant to Section

note 29. The Commission notes that the Regulatory Contract is not before the Commission and, therefore, the Commission is not acting on it.

<sup>99</sup> See Section 17(d)(1) of the Act and Rule 17d-2 thereunder, 15 U.S.C. 78q(d)(1) and 17 CFR 240.17d-2. See also *infra* notes 103-110 and accompanying text.

<sup>100</sup> For example, if failings by FINRA have the effect of leaving BATS Exchange in violation of any aspect of BATS Exchange's self-regulatory obligations, BATS Exchange would bear direct liability for the violation, while FINRA may bear liability for causing or aiding and abetting the violation. See Nasdaq Exchange Registration Order, *supra* note 29 and Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000) (File No. 10-127) (order approving the International Securities Exchange LLC's application for registration as a national securities exchange).

<sup>101</sup> *Id.*

<sup>102</sup> Alternatively, BATS Exchange could demonstrate that it has the ability to fulfill its regulatory obligations.

<sup>103</sup> 15 U.S.C. 78s(g)(1).

17(d) of the Act.<sup>104</sup> Section 17(d) was intended, in part, to eliminate unnecessary multiple examinations and regulatory duplication with respect to members of more than one SRO ("common members").<sup>105</sup> Rule 17d-2 of the Act permits SROs to propose joint plans allocating regulatory responsibilities concerning common members.<sup>106</sup> These agreements, which must be filed with and approved by the Commission, generally cover such regulatory functions as personnel registration, branch office examinations, and sales practices. Commission approval of a 17d-2 plan relieves the specified SRO of those regulatory responsibilities allocated by the plan to another SRO.<sup>107</sup> Many existing SROs have entered in to such agreements.<sup>108</sup>

BATS Exchange has represented to the Commission that BATS Exchange and FINRA intend to file a 17d-2 agreement with the Commission covering common members of BATS Exchange and FINRA. This agreement would allocate to FINRA regulatory responsibility, with respect to common members, for the following:

- FINRA will examine common members of BATS Exchange and FINRA for compliance with federal securities laws, rules and regulations, and rules of BATS Exchange that have been certified by BATS Exchange as identical or substantially similar to FINRA rules.

- FINRA will investigate common members of BATS Exchange and FINRA for violations of federal securities laws, rules or regulations, or BATS Exchange rules that has been certified by BATS Exchange as identical or substantially identical to a FINRA rule.

- FINRA will enforce compliance by common members with federal securities laws, rules and regulations, and rules of BATS Exchange that have been certified by BATS Exchange as

<sup>104</sup> 15 U.S.C. 78q(d).

<sup>105</sup> See Securities Exchange Act Release No. 12935 (October 28, 1976), 41 FR 49091 (November 8, 1976) ("Rule 17d-2 Adopting Release").

<sup>106</sup> 17 CFR 240.17d-2.

<sup>107</sup> See Rule 17d-2 Adopting Release, *supra* note 105.

<sup>108</sup> See, e.g., Securities Exchange Act Release Nos. 13326 (March 3, 1977), 42 FR 13878 (March 14, 1977) (NYSE/Amex); 13536 (May 12, 1977), 42 FR 26264 (May 23, 1977) (NYSE/BSE); 14152 (November 9, 1977), 42 FR 59339 (November 16, 1977) (NYSE/CSE); 13535 (May 12, 1977), 42 FR 26269 (May 23, 1977) (NYSE/CHX); 13531 (May 12, 1977), 42 FR 26273 (May 23, 1977) (NYSE/PSE); 14093 (October 25, 1977), 42 FR 57199 (November 1, 1977) (NYSE/Phlx); 15191 (September 26, 1978), 43 FR 46093 (October 5, 1978) (NASD/BSE, CSE, CHX and PSE); 16858 (May 30, 1980), 45 FR 37927 (June 5, 1980) (NASD/BSE, CSE, CHX and PSE); 42815 (May 23, 2000), 65 FR 34762 (May 31, 2000) (NASD/ISE); and 54136 (July 12, 2006), 71 FR 40759 (July 18, 2006) (NASD/Nasdaq).

identical or substantially similar to FINRA rules.

Because BATS Exchange anticipates entering into this 17d-2 agreement, it has not made provision to fulfill the regulatory obligations that would be undertaken by FINRA under this agreement with respect to common members of BATS Exchange and FINRA.<sup>109</sup> Accordingly, the Commission is conditioning the operation of BATS Exchange on approval by the Commission of a 17d-2 agreement between BATS Exchange and FINRA that allocates the above specified matters to FINRA.<sup>110</sup>

#### 5. Discipline and Oversight of Members

As noted above, a prerequisite for the Commission approval of an exchange's application for registration, an exchange must be organized and have the capacity to carry out the purposes of the Act. Specifically, an exchange must be able to enforce compliance by its members and persons associated with its members with federal securities laws and the rules of the exchange.<sup>111</sup> As noted above, pursuant to the Regulatory Contract, FINRA will perform many of the initial disciplinary processes on behalf of BATS Exchange.<sup>112</sup> For example, FINRA will investigate potential securities laws violations, issue complaints, and conduct hearings pursuant to BATS Exchange rules. Appeals from disciplinary decisions will be heard by the Appeals Committee<sup>113</sup> and the Appeals Committee's decision shall be final. In addition, the Exchange Board may on its own initiative order review of a disciplinary decision.<sup>114</sup>

The BATS Amended and Restated By-Laws and BATS Exchange rules provide that the Exchange has disciplinary jurisdiction over its members so that it can enforce its members' compliance with its rules and the federal securities laws.<sup>115</sup> The Exchange's rules also permit it to sanction members for violations of its rules and violations of the federal securities laws by, among other things, expelling or suspending members, limiting members' activities,

functions, or operations, fining or censuring members, or suspending or barring a person from being associated with a member, or any other fitting sanction.<sup>116</sup> BATS Exchange's rules also provide for the imposition of fines for certain minor rule violations in lieu of commencing disciplinary proceedings.<sup>117</sup> Accordingly, as a condition to the operation of BATS Exchange, a Minor Rule Violation Plan ("MRVP") filed by BATS Exchange under Act Rule 19d-1(c)(2) must be declared effective by the Commission.<sup>118</sup>

The Commission finds that the BATS Exchange's Amended and Restated By-Laws and rules concerning its disciplinary and oversight programs are consistent with the requirements of Sections 6(b)(6) and 6(b)(7)<sup>119</sup> of the Act in that they provide fair procedures for the disciplining of members and persons associated with members. The Commission further finds that the rules of BATS Exchange provide it with the ability to comply, and with the authority to enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulations thereunder, and the rules of BATS Exchange.<sup>120</sup>

#### C. BATS Exchange Trading System

##### 1. Trading Rules

BATS Exchange will operate a fully automated electronic order book. Exchange members and entities that enter into sponsorship arrangements with Exchange members will have access to the BATS Exchange system (collectively, "Users").<sup>121</sup> Users will be able to electronically submit market and various types of limit orders to the Exchange from remote locations. All orders submitted to BATS Exchange will be displayed unless designated otherwise by the BATS Exchange member submitting the order. Displayed orders will be displayed on an anonymous basis at a specified price. Non-displayed orders will not be displayed but will be ranked in the BATS Exchange system at a specified price.<sup>122</sup> The BATS Exchange system

will continuously and automatically match orders pursuant to price/time priority, except that displayed orders will have priority over non-displayed orders at the same price.<sup>123</sup>

The BATS Exchange system is designed to comply with Rule 611 of Regulation NMS<sup>124</sup> by requiring that, for any execution to occur on the Exchange during regular trading hours, the price must be equal to, or better than, any "protected quotation" within the meaning of Regulation NMS ("Protected Quotation"), unless an exception to Rule 611 of Regulation NMS applies.<sup>125</sup> BATS Exchange will direct any orders or portion of orders that cannot be executed in their entirety to away markets for execution through BATS Trading, unless the terms of the orders direct the Exchange not to route such orders away.<sup>126</sup>

BATS Exchange intends to operate as an automated trading center in compliance with Rule 600(b)(4) of Regulation NMS.<sup>127</sup> BATS Exchange will display automated quotations at all times except in the event that a systems malfunction renders the system incapable of displaying automated quotations.<sup>128</sup> The Exchange has designed its rules relating to orders, modifiers, and order execution to comply with the requirements of Regulation NMS, including an immediate-or-cancel functionality.<sup>129</sup> These proposed rules include accepting orders marked as intermarket sweep orders, which will allow orders so designated to be automatically matched and executed without reference to Protected Quotations at other trading centers,<sup>130</sup> and routing orders marked as intermarket sweep orders by a User to a specific trading center for execution.<sup>131</sup> In addition, BATS Exchange rules address locked and crossed markets,<sup>132</sup> as required by Rule 610(d) of Regulation NMS.<sup>133</sup> The Commission believes that BATS Exchange's rules are consistent with the Act, in particular with the requirements of Rule 610(d) and Rule 611 of Regulation NMS.

As stated above, BATS Exchange intends to operate as an automated

<sup>109</sup> The Commission notes that regulation that is to be covered by the 17d-2 agreement for common members will be carried out by FINRA under the Regulatory Contract for BATS Exchange members that are not also members of FINRA.

<sup>110</sup> Alternatively, BATS Exchange could demonstrate that it has the ability to fulfill its regulatory obligations.

<sup>111</sup> See 15 U.S.C. 78f(b)(1).

<sup>112</sup> See *supra* note 97 and accompanying text.

<sup>113</sup> See BATS Exchange Rule 8.10(b).

<sup>114</sup> See BATS Exchange Rule 8.10(c).

<sup>115</sup> See generally BATS Exchange Amended and Restated By-Laws Article X and BATS Exchange Rules Chapters II and VIII.

<sup>116</sup> See BATS Exchange Rules 2.2 and 8.1(a).

<sup>117</sup> See BATS Exchange Rule 8.15 and Amendment No. 2.

<sup>118</sup> 17 CFR 240.19d-1(c)(2).

<sup>119</sup> 15 U.S.C. 78f(b)(6) and (b)(7).

<sup>120</sup> See Section 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1).

<sup>121</sup> To obtain authorized access to the BATS Exchange System, each User must enter in to a User Agreement with the Exchange. See BATS Exchange Rule 11.3(a).

<sup>122</sup> BATS Exchange rules do not provide for specialists or market makers.

<sup>123</sup> See BATS Exchange Rule 11.8.

<sup>124</sup> 17 CFR 242.611.

<sup>125</sup> See BATS Exchange Rule 11.9.

<sup>126</sup> See BATS Exchange Rule 11.9(a)(2).

<sup>127</sup> 17 CFR 242.600(b)(4).

<sup>128</sup> See BATS Exchange Rule 11.9(c); see also 17 CFR 242.600(b)(3).

<sup>129</sup> See BATS Exchange Rules 11.5 and 11.9; see also 17 CFR 242.600(b)(3).

<sup>130</sup> See BATS Exchange Rule 11.5(d)(1).

<sup>131</sup> See BATS Exchange Rule 11.5(d)(2).

<sup>132</sup> See BATS Exchange Rule 11.16.

<sup>133</sup> 17 CFR 242.610(d).

trading center and have its best bid and best offer be a Protected Quotation.<sup>134</sup> To meet their regulatory responsibilities under Rule 611(a) of Regulation NMS, market participants must have sufficient notice of new Protected Quotations, as well as all necessary information (such as final technical specifications).<sup>135</sup> Therefore, the Commission believes that it would be a reasonable policy and procedure under Rule 611(a) for industry participants to begin treating BATS Exchange's best bid and best offer as a Protected Quotation within 90 days after the date of this order, or such later date as BATS Exchange begins operation as a national securities exchange.

## 2. Section 11 of the Act

Section 11(a)(1) of the Act<sup>136</sup> prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, "covered accounts") unless an exception applies. Rule 11a2-2(T)<sup>137</sup> under the Act, known as the "effect versus execute" rule, provides exchange members with an exemption from the Section 11(a)(1) prohibition. Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute the transactions on the exchange. To comply with Rule 11a2-2(T)'s conditions, a member: (i) Must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;<sup>138</sup> (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the Rule.

In a letter to the Commission,<sup>139</sup> BATS Exchange requested that the Commission concur with BATS

Exchange's conclusion that BATS Exchange members that enter orders into the BATS Exchange system satisfy the requirements of Rule 11a2-2(T). For reasons set forth below, the Commission believes that BATS Exchange members entering orders into the BATS Exchange system would satisfy the conditions of the Rule.

The Rule's first condition is that orders for covered accounts be transmitted from off the exchange floor. The BATS Exchange system receives orders electronically through remote terminals or computer-to-computer interfaces. In the context of other automated trading systems, the Commission has found that the off-floor transmission requirement is met if a covered account order is transmitted from a remote location directly to an exchange's floor by electronic means.<sup>140</sup> Since the BATS Exchange system receives orders electronically through remote terminals or computer-to-computer interfaces, the Commission believes that the BATS Exchange system satisfies the off-floor transmission requirement.

Second, the rule requires that the member not participate in the execution of its order. BATS Exchange represented that at no time following the submission of an order is a member able to acquire control or influence over the result or timing of an order's execution.<sup>141</sup>

<sup>140</sup> See, e.g., Nasdaq Exchange Registration Order, *supra* note 29; and Securities Exchange Act Release Nos. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (order approving the Boston Options Exchange as an options trading facility of the Boston Stock Exchange); 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (order approving Archipelago Exchange ("ArcaEx") as electronic trading facility of the Pacific Exchange ("PCX") ("ArcaEx Order")); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (regarding NYSE's Off-Hours Trading Facility); 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) (regarding the American Stock Exchange ("Amex") Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX Communications and Execution System, and the Philadelphia Stock Exchange's ("Phlx") Automated Communications and Execution System ("1979 Release")); and 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978) (regarding the NYSE's Designated Order Turnaround System ("1978 Release")).

<sup>141</sup> See BATS Exchange 11(a) Letter, *supra* note 139. The member may cancel or modify the order, or modify the instructions for executing the order, but only from off the Exchange floor. *Id.* The Commission has stated that the non-participation requirement is satisfied under such circumstances so long as such modifications or cancellations are also transmitted from off the floor. See Securities Exchange Act Release No. 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978) (stating that the "non-participation requirement does not prevent initiating members from canceling or modifying orders (or the instructions pursuant to which the initiating member wishes orders to be executed) after the orders have been transmitted to the

According to BATS Exchange, the execution of a member's order is determined solely by what orders, bids, or offers are present in the system at the time the member submits the order. Accordingly, the Commission believes that a BATS Exchange member would not participate in the execution of an order submitted into the BATS Exchange system.

Third, Rule 11a2-2(T) requires that the order be executed by an exchange member who is unaffiliated with the member initiating the order. The Commission has stated that this requirement is satisfied when automated exchange facilities, such as the BATS Exchange system, are used, as long as the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange.<sup>142</sup> BATS Exchange has represented that the design of the BATS Exchange system ensures that no member has any special or unique trading advantage in the handling of its orders after transmitting its orders to BATS Exchange.<sup>143</sup> Based on BATS Exchange's representation, the Commission believes that the BATS Exchange system satisfies this requirement.

Fourth, in the case of a transaction effected for an account with respect to which the initiating member or an associated person thereof exercises investment discretion, neither the initiating member nor any associated person thereof may retain any compensation in connection with effecting the transaction, unless the person authorized to transact business for the account has expressly provided otherwise by written contract referring to Section 11(a) of the Act and Rule 11a2-2(T).<sup>144</sup> BATS Exchange

executing member, provided that any such instructions are also transmitted from off the floor").

<sup>142</sup> In considering the operation of automated execution systems operated by an exchange, the Commission noted that while there is no independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See 1979 Release, *supra* note 140.

<sup>143</sup> See BATS Exchange 11(a) Letter, *supra* note 139.

<sup>144</sup> 17 CFR 240.11a2-2(T)(a)(2)(iv). In addition, Rule 11a2-2(T)(d) requires a member or associated person authorized by written contract to retain compensation, in connection with effecting transactions for covered accounts over which such member or associated person thereof exercises

<sup>134</sup> 17 CFR 242.600(b)(58).

<sup>135</sup> See Securities Exchange Act Release No. 53829 (May 18, 2006), 71 FR 30038, 30041 (May 24, 2006).

<sup>136</sup> 15 U.S.C. 78k(a)(1).

<sup>137</sup> 17 CFR 240.11a2-2(T).

<sup>138</sup> The member may, however, participate in clearing and settling the transaction.

<sup>139</sup> See letter to David Shillman, Associate Director, Division of Trading and Markets, Commission, from J. Craig Long, Foley & Lardner LLP, dated June 24, 2008 ("BATS Exchange 11(a) Letter").



represented that BATS Exchange members trading for covered accounts over which they exercise investment discretion must comply with this condition in order to rely on the rule's exemption.<sup>145</sup>

#### D. Section 11A of the Act

Section 11A of the Act and the rules thereunder form the basis of our national market system and impose requirements on exchanges to implement its objectives. Specifically, national securities exchanges are required, under Rule 601 of Regulation NMS,<sup>146</sup> to file transaction reporting plans regarding transactions in listed equity and Nasdaq securities that are executed on their facilities. Currently registered exchanges satisfy this requirement by participating in the Consolidated Transaction Association Plan ("CTA Plan") for listed equities and the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis ("Nasdaq UTP Plan") for Nasdaq securities.<sup>147</sup> Before BATS Exchange can begin operating as an exchange, it must join these plans as a participant.

National securities exchanges are required, under Rule 602 of Regulation NMS,<sup>148</sup> to collect bids, offers, quotation sizes and aggregate quotation sizes from those members who are responsible broker or dealers. National securities exchanges must then make this information available to vendors at all times when the exchange is open for trading. The current exchanges satisfy this requirement by participating in the Consolidated Quotation System Plan ("CQ Plan") for listed equity securities

investment discretion, to furnish at least annually to the person authorized to transact business for the account a statement setting forth the total amount of compensation retained by the member in connection with effecting transactions for the account during the period covered by the statement. See 17 CFR 240.11a2-2(T)(d). See also 1978 Release, *supra* note 140 (stating "[t]he contractual and disclosure requirements are designed to assure that accounts electing to permit transaction-related compensation do so only after deciding that such arrangements are suitable to their interests").

<sup>145</sup> See BATS Exchange 11(a) Letter, *supra* note 139.

<sup>146</sup> 17 CFR 242.601.

<sup>147</sup> These plans also satisfy the requirement in Rule 603 that national securities exchanges and national securities associations act jointly pursuant to an effective national market system plan to disseminate consolidated information, including a national best bid and offer, and quotations for and transactions in NMS stocks. See 17 CFR 242.603. See also Nasdaq Exchange Registration Order, *supra* note 29.

<sup>148</sup> 17 CFR 242.602.

and the Nasdaq UTP Plan for Nasdaq securities. Before BATS Exchange can begin operating as an exchange it also must join the CQ Plan as a participant, in addition to the CTA Plan and the Nasdaq UTP Plan.

Finally, national securities exchanges must make available certain order execution information pursuant to Rule 605 of Regulation NMS.<sup>149</sup> Current exchanges have standardized the required disclosure mechanisms by participating in the Order Execution Quality Disclosure Plan.<sup>150</sup> BATS Exchange must join this plan before it begins operations as an exchange.

#### E. Order Routing

As noted above in Section III.A., BATS Exchange proposes to offer routing services to its Users through its affiliated broker-dealer, BATS Trading. BATS Trading will provide "outbound" routing of orders from the Exchange to other trading centers (such function of BATS Trading is referred to as the "Outbound Router"), and BATS Trading will engage in no other activities unless approved by the Commission.<sup>151</sup> The Outbound Router function of BATS Trading will operate as a facility (as defined in Section 3(a)(2) of the Act) of the Exchange. As such, the Outbound Router function of BATS Trading is subject to the Exchange's and the Commission's continuing oversight. In particular, and without limitation, under the Act, the Exchange is responsible for filing with the Commission proposed rule changes and fees relating to the BATS Trading Outbound Router function and BATS Trading Outbound Router function will be subject to exchange non-discrimination requirements.<sup>152</sup>

BATS Trading will be a member of FINRA, an SRO unaffiliated with BATS Exchange or any of its affiliates, that is its designated examining authority.<sup>153</sup> Also, BATS Exchange will establish and maintain procedures and internal controls reasonably designed to restrict the flow of confidential and proprietary information between BATS Exchange and its facilities, and any other entity, including any affiliate of BATS Trading, and, if BATS Trading or any of its affiliates engages in any other business activities other than the Outbound Router function, between the segment of BATS Trading or its affiliate that provides the other business activities

<sup>149</sup> 17 CFR 242.605.

<sup>150</sup> See Securities Exchange Act Release No. 44177 (April 12, 2001), 66 FR 19814 (April 17, 2001).

<sup>151</sup> See BATS Exchange Rule 2.11(a)(4).

<sup>152</sup> See BATS Exchange Rule 2.11(a)(1).

<sup>153</sup> See BATS Exchange Rule 2.11(a)(2).

and the Outbound Router function.<sup>154</sup> In addition, the books, records, premises, officers, directors, agents, and employees of BATS Trading, as a facility of the Exchange, will be deemed to be those of the Exchange for purposes of and subject to oversight pursuant to the Act.<sup>155</sup> Further, Users are not required to use the Outbound Router function of BATS Trading to route orders,<sup>156</sup> and a User is free to route its orders to other market centers through alternative means.<sup>157</sup>

In light of the protections discussed above, the Commission believes that BATS Exchange rules and procedures regarding use of BATS Trading to route orders to away markets are consistent with the Act.<sup>158</sup>

#### F. Listing Requirements/Unlisted Trading Privileges

BATS Exchange initially does not intend to list any securities. Accordingly, BATS Exchange has not proposed rules that would allow it to list any securities at this time.<sup>159</sup> Instead, BATS Exchange has proposed to trade securities pursuant to unlisted trading privileges, consistent with Section 12(f) of the Act and Rule 12f-5 thereunder. Rule 12f-5 requires an exchange that extends unlisted trading privileges to securities to have in effect a rule or rules providing for transactions in the class or type of security to which the exchange extends unlisted trading privileges.<sup>160</sup> BATS Exchange's proposed rules require that any security traded on the BATS Exchange be registered under the Act and listed on the New York Stock Exchange LLC, NYSE Arca, the American Stock Exchange LLC, or The NASDAQ Stock Market LLC. BATS Exchange's proposed

<sup>154</sup> See BATS Exchange Rule 2.11(a)(5).

<sup>155</sup> See BATS Exchange Rule 2.11(b).

<sup>156</sup> A User that does not wish to use the Outbound Router function of BATS Trading could submit an Immediate-or-Cancel Order or another order type that is not eligible for order routing pursuant to BATS Exchange rules, such as a BATS Only Order. See BATS Exchange Rule 11.5.

<sup>157</sup> See BATS Exchange Rule 2.11(a)(3).

<sup>158</sup> The Commission has approved similar arrangements for other SROs. See, e.g., NOM Approval Order and NSX Blade Approval Order, *supra* note 94.

<sup>159</sup> BATS Exchange has incorporated listing standards for certain derivative securities products in its rules. However, BATS Exchange's rules will prohibit BATS Exchange from listing any derivative security product pursuant to these listing standards until BATS Exchange submits a proposed rule change to the Commission to amend its listing standards to comply with Rule 10A-3 under the Act and incorporate qualitative listing criteria. See BATS Exchange Rule 14.1(a).

<sup>160</sup> 17 CFR 240.12f-5. See also Securities Exchange Act Release No. 35737 (April 21, 1995), 60 FR 20891 (April 28, 1995) (adopting Rule 12f-5).

rules provide for transactions in the class or type of security to which the exchange intends to extend unlisted trading privileges.<sup>161</sup> In addition, pursuant to its rules, BATS Exchange will cease trading any equity security admitted to unlisted trading privileges that is no longer listed on one of these exchanges. The Commission finds that these rules are consistent with the Act.<sup>162</sup>

#### IV. Exemption from Section 19(b) of the Act With Regard to FINRA Rules Incorporated by Reference

BATS Exchange proposes to incorporate by reference certain FINRA rules as Exchange rules. Thus, for certain Exchange rules, Exchange members will comply with an Exchange rule by complying with the FINRA rule referenced.<sup>163</sup> In connection with its proposal to incorporate FINRA rules by reference, BATS Exchange requested, pursuant to Rule 240.0-12,<sup>164</sup> an exemption under Section 36 of the Act from the rule filing requirements of Section 19(b) of the Act for changes to those BATS Exchange rules that are effected solely by virtue of a change to a cross-referenced FINRA rule.<sup>165</sup> BATS Exchange proposes to incorporate by reference categories of rules (rather than individual rules within a category) that are not trading rules. BATS Exchange agrees to provide written notice to its members whenever a proposed rule change to a FINRA rule that is incorporated by reference is proposed.<sup>166</sup>

Using its authority under Section 36 of the Act,<sup>167</sup> the Commission previously exempted certain SROs from the requirement to file proposed rule

changes under Section 19(b) of the Act.<sup>168</sup> Each such exempt SRO agreed to be governed by the incorporated rules, as amended from time to time, but is not required to file a separate proposed rule change with the Commission each time the SRO whose rules are incorporated by reference seeks to modify its rules.

In addition, each such exempt SRO incorporated by reference only regulatory rules (*i.e.*, margin, suitability, arbitration), not trading rules, and incorporated by reference whole categories of rules (*i.e.*, did not “cherry-pick” certain individual rules within a category). Each such exempt SRO had reasonable procedures in place to provide written notice to its members each time a change is proposed to the incorporated rules of another SRO in order to provide its members with notice of a proposed rule change that affects their interests, so that they would have an opportunity to comment on it.

The Commission is granting BATS Exchange’s request for exemption, pursuant to Section 36 of the Act, from the rule filing requirements of Section 19(b) of the Act with respect to the rules that BATS Exchange proposes to incorporate by reference. This exemption is conditioned upon BATS Exchange providing written notice to its members whenever FINRA proposes to change a rule that BATS Exchange has incorporated by reference. The Commission believes that this exemption is appropriate in the public interest and consistent with the protection of investors because it will promote more efficient use of Commission and SRO resources by avoiding duplicative rule filings based on simultaneous changes to identical rules sought by more than one SRO. Consequently, the Commission grants BATS Exchange’s exemption request.

#### V. Conclusion

*It is ordered* that the application of BATS Exchange for registration as a national securities exchange be, and hereby is, granted.

*It is further ordered* that operation of BATS Exchange is conditioned on the satisfaction of the requirements below:

**A. Participation in National Market System Plans.** BATS Exchange must join the CTA Plan, the CQ Plan, the Nasdaq UTP Plan, and the Order Execution Quality Disclosure Plan.

**B. Intermarket Surveillance Group.** BATS Exchange must join the Intermarket Surveillance Group.

<sup>168</sup> See, *e.g.*, Securities Exchange Act Release No. 49260 (February 17, 2004), 69 FR 8500 (February 24, 2004) and Nasdaq Exchange Registration Order, *supra* note 29.

**C. Minor Rule Violation Plan.** A MRVP filed by BATS Exchange under Rule 19d-1(c)(2) must be declared effective by the Commission.<sup>169</sup>

**D. 17d-2 Agreement.** An agreement pursuant to Rule 17d-2<sup>170</sup> between FINRA and BATS Exchange that allocates to FINRA regulatory responsibility for those matters specified above<sup>171</sup> must be approved by the Commission, or BATS Exchange must demonstrate that it independently has the ability to fulfill all of its regulatory obligations.

**E. Regulatory Contract.** The Regulatory Contract between BATS Exchange and FINRA containing those matters specified above<sup>172</sup> must be executed and the provisions in the Regulatory Contract that will specify the BATS Exchange and Commission rules for which FINRA will provide certain of the regulatory functions under the Regulatory Contract must be finalized, or BATS Exchange must demonstrate that it independently has the ability to fulfill all of its regulatory obligations.

**F. Examination by the Commission.** BATS Exchange must have, and represent in a letter to the staff in the Commission’s Office of Compliance Inspections and Examinations that it has, adequate procedures and programs in place to effectively regulate BATS Exchange.

*It is further ordered*, pursuant to Section 36 of the Act,<sup>173</sup> that BATS Exchange shall be exempt from the rule filing requirements of Section 19(b) of the Act<sup>174</sup> with respect to the FINRA rules BATS Exchange proposes to incorporate by reference into BATS Exchange’s rules, subject to the conditions specified in this Order.

By the Commission (Chairman Cox and Commissioners Casey, Aguilar, and Paredes); Commissioner Walter not participating.

**Florence E. Harmon,**

*Acting Secretary.*

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<sup>161</sup> *Id.* BATS Exchange’s rules currently do not provide for the trading of options, security futures, or other similar instruments.

<sup>162</sup> BATS Exchange has represented to the Commission that it intends to phase-in the trading of securities currently trading on the BATS ECN to BATS Exchange, and that it will provide appropriate advance notice to its members of the phase-in schedule. The Commission believes that this approach is appropriate and should help maintain an orderly transition to the BATS Exchange.

<sup>163</sup> BATS Exchange proposed to incorporate by reference the 12000 and 13000 Series of FINRA’s NASD Manual, the NASD Code of Arbitration Procedure for Customer and Industry Disputes. See BATS Exchange Rule 9.1.

<sup>164</sup> See 17 CFR 240.0-12.

<sup>165</sup> See letter to Nancy Morris, Secretary, Commission, from J. Craig Long, Foley & Lardner, dated June 24, 2008.

<sup>166</sup> BATS Exchange will provide such notice via a posting on the same Web site location where BATS Exchange will post its own rule filings pursuant to Commission Rule 19b-4(j). The posting will include a link to the location on the FINRA Web site where the proposed rule change is posted. See *id.*

<sup>167</sup> 15 U.S.C. 78mm.

<sup>169</sup> 17 CFR 240.19d-1(c)(2).

<sup>170</sup> 17 CFR 240.17d-2.

<sup>171</sup> See *supra* notes 103 to 110 and accompanying text.

<sup>172</sup> See *supra* notes 95 to 102 and accompanying text.

<sup>173</sup> 15 U.S.C. 78mm.

<sup>174</sup> 15 U.S.C. 78s(b).