

Dear BATS Customers and Members of the Trading Community,

In this edition of our newsletter you will find ...

- \* European Equity Trading - *On the Verge of a Tipping Point*
- \* BOLT – Flash – ELP
- \* Market Share Update

### **European Equity Trading - *On the Verge of a Tipping Point***

I spent two weeks in the latter part of June visiting customers (both current and prospective) in major European cities, and my outlook is extremely positive for the future of equity trading in Europe.

I have long felt that the opportunities for trading in Europe have been restrained by slow platforms, prohibitive pricing models, high-volume penalties, expensive clearing, inter-market routing barriers, and a lack of consistent standards. These and other similar issues have, for the most part, simply been accepted as the status quo. Until recently, that is.

On my journey I met with a large number of active participants in the European market place. Through these meetings I found a surprising level of frustration regarding the legacy trading environment, but at the same time a heightened optimism for the changing landscape that is currently unfolding. I am seeing what the active trading community is also seeing ... clear signs of progress on the many issues mentioned above.

As these stumbling blocks are knocked down and removed, the trading opportunities are going to explode in Europe. Comparing apples-to-apples, combined trading in all major European markets accounts for \$20B to \$30B daily, whereas the total notional value traded in the US equity market is between \$200B and \$300B daily ... a full 10 fold difference.

It's important to say it again ... the major problems historically holding back equity trading in Europe are high access fees, lackluster platform performance, isolated liquidity pools, absence of industry standards, and high clearance/settlement fees.

Good news – progress has been made and continues in each of these areas!

With respect to access fees and platform performance, the MTFs are leading the way with vast improvements over the incumbent exchanges. Standards are forming around common tick sizes and uniform symbology. Speaking of clearance and settlement fees, we predict interoperability and competition among CCPs will soon yield critical efficiencies. And finally, linkages between markets in the form of broker/dealer smart order routers and inter-market routing will soon fully develop based on strong industry demand. BATS Europe is active in all these areas, and often leading the charge.

As these improvements continue to unfold, I am predicting a 2X to 5X explosion in Europe over the next 12 - 18 months in each of the following:

- 1) Total notional value traded daily
- 2) Total number of active securities traded daily
- 3) Total number of active participants trading daily

The signs of order flow migration are already obvious. Whereas the major incumbent exchanges previously held a majority market share in the trading of their own country listings, often 85% to 95%, those markets are now handling 60% to 80% daily. Short of a significant change in strategy, this is a downward trend I expect to continue over the next few years, bottoming out for most incumbent exchanges in the 30% to 40% range for their home securities.

Similar pressures are being applied to traditional market making firms at the same time. It's getting harder to make reasonably sized markets using methods that worked just a few years ago. A new breed of liquidity provider is filling the gap, and these new participants are applying their own brand of healthy pressure on market centers to operate more efficiently.

This new breed of participant, the *Automated Market Maker*, is a driving force for change in the European landscape. The automated market makers are lean, efficient, and well positioned to compete in a world in which trading spreads will be under constant compression. Exchanges will need to respond in kind, which will drive exchange access fees down further, force linkages between market centers, and influence clearing firms to become more efficient and reduce clearing/settlement fees.

We have seen a number of automated market making firms come over to Europe from the US in the last several months. Even more encouraging for me was the revelation that several European automated market firms have been operating for some time and are already a big part of the European equity landscape. The platforms offered by some of the MTFs (BATS, Chi-X, etc.) are allowing these automated market makers to unleash their potential. If the incumbent exchanges can offer similar trading experiences in terms of performance and economics, they too might benefit from the massive explosion in trading that is possible in the coming months. On the other hand, if the incumbent exchanges ignore these new trends, they will be left behind.

Case in point is the pricing model used by incumbent exchanges. Of the three major exchanges in Europe, Deutsche Borse and NYSE/Euronext continue to operate on a "taker/taker" price model. This model ignores the economic forces that are putting increasing pressure on liquidity providers to be more efficient. The London Stock Exchange had been leading the group of three incumbents with a "maker/taker" price model, however they recently announced a change in strategic direction and will revert to a "taker/taker" model in September. Historically we have seen the taker/taker model act as a barrier to tremendous growth potential in trading activity.

To put it simply, there has been a high level of *trading friction* embedded in the European market place historically, and as that friction is removed, bit by bit, the trading opportunities will expand ... dramatically. The pie will get bigger, and the nimble and efficient players will dominate the new landscape. BATS is excited to be on the forefront of this evolution and we welcome the challenges ahead.

## **BOLT – Flash – ELP**

Back in the US, the securities industry is working through a recent controversial development in market structure. Once you peel back all the layers, the issue boils down to the definition of “immediate”. We live in a world of wide ranging turnaround times. We measure the time it takes to process an electronic order in millionths of a second, but we measure the time it takes to settle a trade in multiple days. With such a wide range of time frames in our industry, it can be hard to nail down a definition of “immediate” that everybody can agree on. Hence the controversy over new functionality that BATS and Nasdaq recently began offering, partly in response to similar functionality DirectEdge has been using for some time.

The controversial functionality has to do with a market center holding a marketable order long enough to exploit an opportunity for *immediate* execution within its private group of members. That’s the essence of what BOLT (BATS), Flash Orders (Nasdaq), and ELP (DirectEdge) are each doing. Does immediate mean 3 seconds, ½ second, or 20 milliseconds? Or should immediate mean “execution against contra-orders already known at the exact moment of exposure”? For any period of time beyond a truly instantaneous moment, i.e. zero elapsed time, the functionality in question begins to raise potential concerns. While there are differences in the BATS-Nasdaq-DirectEdge unique implementations, the common thread between them is how marketable orders are handled after they have been matched against resting book liquidity “for some period of elapsed time” before being routed to away markets.

There are unresolved questions regarding these implementations that industry groups and individual participants have raised in comment letters to the SEC. The topic and subsequent debate have also come up a number of times on panels at trade show conferences this summer.

Our position on this debate is clear: the SEC currently deems the BOLT and Flash functionality legal and compliant with the Act. BATS stands ready, however, to participate in an industry review of potential issues associated with this functionality. From our perspective, potential issues common to BOLT, Flash, and ELP worth further investigation are as follows:

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

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

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

Customers who take the risk of displaying orders in a public market are helping to establish reference prices as a vital part of the price discovery process. Under Reg NMS, such orders that form a market’s Protected Quote are protected from being traded through their limit prices but are not protected from another market trading at the same price. While that protection continues to exist with the implementation of BOLT/Flash/ELP, it is likely that BOLT/Flash/ELP create a greater frequency of instances in which such Protected Quotes are denied an execution they might have otherwise received, thereby creating a disincentive to post aggressive limit orders and harming the price discovery process.

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

In the current Reg NMS environment, both the spirit and the letter of the law speak to the avoidance of locked markets. While the debate around whether locked markets are good or bad is interesting, it's irrelevant in an environment where the regulations prohibit it. In all three cases (BOLT/Flash/ELP), depending on your vantage point and definition of "immediate", it's possible to see how a virtual locked market situation is created. During the period in which marketable orders are being exposed to a private network of users, those same orders are effectively priced at a locking price to other displayed markets quotes.

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

The consolidated tape has long been the industry reference for the market's top of book quotes. It can be used as a benchmark for best execution, and it can be used as a basis for determining the NBBO (National Best Bid and Best Offer). In BOLT, Flash, and ELP, "exposed orders" are not reflected in the consolidated tape, which might create a potentially harmful disconnect in the public quote stream over time.

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

The general obligation to seek access to "reasonably available" prices that are better than the NBBO is a well established tenet of the best execution obligation. BOLT, Flash, and ELP raise questions about whether the better quotations temporarily shown to a private network of users are truly "reasonably available" to many brokers handling agency orders. To be compliant with their best execution obligations, are all such brokers required to go to the expense of taking in direct feeds and seeking access to these fleeting better-priced quotations? Or, in doing so are they running the risk that not only will they fail to access the better priced quotations but will also miss the published markets for their customers? It may be that firms' experience in seeking to access these quotations will provide the only concrete guide to determining their relevance to satisfaction of best execution obligations, but it seems that this issue remains open for discussion.

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

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

As stated above, BATS recognizes the potential benefit of further discussion and debate surrounding the BOLT/Flash/ELP functionality and the associated potential concerns. While it may spark an even stronger and wider debate, we would welcome a discussion around whether locked markets are in fact good for the industry. If locked markets were accepted by the regulatory framework, and all quotes were then reflected in the consolidated tape, many, if not all of the issues above might find acceptable resolution.

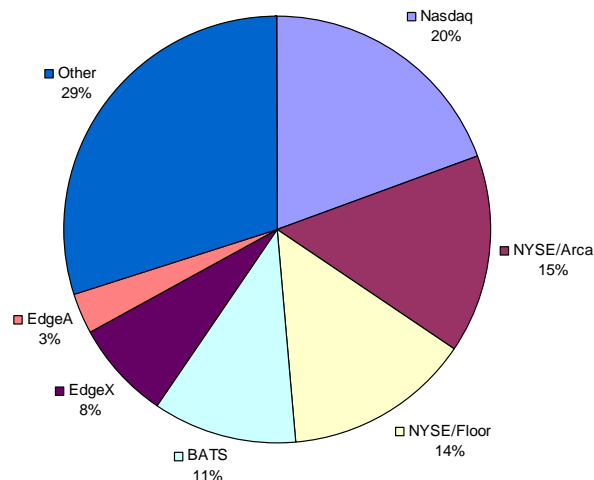
In conjunction with a regulatory review of the BOLT/Flash/ELP functionality in the equities market, BATS would suggest that the "step-up auction" functionality found in the options market also be reviewed. The common theme in both cases is the definition of "immediate" as a critical point in determining how to best handle marketable orders.

## Market Share Update

BATS has continued its long standing upward growth trend. In fact, while most other US market centers have been losing ground, BATS has shown consistent market share growth during the 2<sup>nd</sup> quarter. As a snapshot update, the average daily matched market share among US markets during the last two weeks of June (June 15<sup>th</sup> – June 30<sup>th</sup>) are as follows:

Nasdaq – 19.56%  
NYSE/Arca – 14.81%  
NYSE/Floor – 14.17%  
BATS – 10.87%  
DirectEdge/EdgeX \* – 7.6%  
DirectEdge/EdgeA \* – 3.1%

\* Note: Values for DirectEdge are estimated, based on best available information. All other values are pulled directly from the consolidated tape and represent daily average matched market share (excluding odd-lot transactions).



In Europe, BATS has increased its share across all 12 markets in which we are active. We have crossed the 5% threshold in FTSE 100, CAC 40, DAX, and AEX securities, and are running close to 5% in other major indices as well. The BATS Europe team continues to sign up new participants each week and the trading community surrounding the BATS Europe MTF is benefiting from critical mass (i.e. the network effect). The trend for Europe is clearly pointing up, and as incumbent exchange market share comes under pressure, BATS is in a great position to offer its customers a better alternative for trading European securities.

## Thank you

We would like to thank our customers in the US and Europe for their business. We make a habit of listening to our customers and building features into our platforms that meet the high demands of the trading and investing community. Our technology team is delivering a continuous stream of functionality and performance improvements that are benefiting our wide and diverse customer base. That is one of the key BATS advantages, and one the ways that we continue to earn our growing market share month after month.

As always, your comments and feedback are welcome.

Sincerely,  
Joe Ratterman

Chairman, President and CEO  
BATS ... Making Markets Better