

Dear BATS Customers and Members of the Trading Community,

In this edition of our newsletter we will cover the following three topics:

*** Healthy Debate – The Options Directed Order proposal.**

BATS is challenging the status quo in the Equity Options Market.

*** Market Quality Incentives – Pricing innovation yet again.**

BATS introduces NBBO Setter, with more targeted incentives to follow.

*** Keep it simple, Stupid!**

Harmonization between various rules and different markets should be a key goal.



HEALTHY DEBATE – THE OPTIONS DIRECTED ORDER PROPOSAL

“If you want to make enemies, try to change something.” - Woodrow Wilson

“The world hates change, yet it is the only thing that has brought progress.”- Charles Kettering

In a recent petition to the SEC objecting to the approval of our Directed Order program, the other US options exchanges argued that (i) the program is different from their current payment for order flow (PFOF) programs *and therefore* not good for the market, (ii) that the SEC staff erred in approving it, (iii) that they don't think it will work the way BATS thinks it will, (iv) that it could lead to internalization, and finally (v) that if BATS implements the program, they will all be forced to implement similar programs too.

To be clear, our goal with introducing the innovative Directed Order program is to bring better prices in listed equity options for our customers by incenting market makers to provide deeper displayed liquidity and tighter bid/offer spreads.

We see the existence of PFOF relationships, on the other hand, as resulting in less transparency, less competition, and inferior prices for retail customers. BATS is attempting to bring retail customer order flow to a price-time market and create a mechanism that allows for competition for those orders, resulting in a better price experience for the customer.

Pressure from our competitors is no reason to back away from our goal of Making Markets Better. We believe PFOF mechanisms prevail today because they have not had a legitimate challenger. We will continue to challenge the status quo, because we don't believe it reflects the best market structure available for trading options.

That being said, the current form of our Directed Order program may not yet fully address some of the potential risks that our customers have raised with us. We are working closely with our customers and are listening to their feedback. The rule has many elements that are broadly seen as positive, but when taken as a whole, there may be a few concerns that could be better addressed.

For example, some see our Directed Order program as facilitating a potential trend towards increased internalization, and others have highlighted that there may be a disincentive for market makers that don't currently have customer relationships. Of course, it is difficult to determine the actual outcome without implementing the pilot program, but we certainly agree that outcomes like these are not desirable (nor are they the intent of the program). As a result, we will continue collaborating with our customers on possible design improvements in the weeks ahead, and we would like to thank our customers for the feedback and support they provided over the last several months.

In the meantime, we will retract the currently approved rule until we are confident that the final result will, in fact, make markets better. The end goal remains to provide an alternative mechanism to existing and prevalent PFOF programs, which would enable market makers to compete by providing better prices directly to retail customers rather than through payments to the customer's broker.

MARKET QUALITY INCENTIVES – PRICING INNOVATION YET AGAIN

While we aren't quite there yet with the options Directed Order program, we are very pleased with our latest pricing innovation, the "NBBO Setter" program. This has been such a hit on the BATS Options market that we've recently rolled it out on our two U.S. equity exchanges as well.

The NBBO Setter concept is the first of many innovations to come from BATS based on a new paradigm shift in pricing models. Our previous pricing models were flat, applying standard access economics to all customers equally at all times.

At first glance that sounds attractive, especially when compared to our competitors' models that typically involve volume tiers. With price models that are based solely on volume tiers, the economics are disproportionately directed to "bigger" customers. This can have the unfortunate effect of keeping bigger clients bigger and smaller clients smaller, which is why BATS historically avoided using volume tiers.

With constructs like NBBO Setter, however, we have found a way to direct incremental economics towards those "orders" and "client behaviors" that can improve the quality of the market for all participants. In other words, we aren't just directing better economics to clients because of their *size*, we are also directing

incentives to them based on their *actions*, specifically those actions that can actually improve market quality.

While the NBBO Setter program rewards *tighter* markets, our next initiative is a market maker quoting incentive that will reward *deeper* liquidity. This will be rolled out in August on the BATS Options market, with similar constructs planned for our equities exchanges in the near future. Stay tuned for even more “Market Quality Incentives” that will be announced in the coming months.

Targeting and incentivizing better *orders and behaviors* is a fresh and innovative perspective in pricing models, one that not only benefits those who receive the incentives directly, but equally provides a better experience for all BATS customers in the form of improved market quality.

KEEP IT SIMPLE, STUPID!

A quick visit to Wikipedia provides some instructive background on the KISS principle, which states “... that [simplicity](#) should be a key goal in [design](#), and that unnecessary complexity should be avoided.”

[Kelly Johnson](#), a lead engineer at the [Lockheed Skunk Works](#), appears to be responsible for having introduced the concept. The genesis for his principle has remarkable similarities to today’s developing regulatory landscape. Johnson challenged his team to design their fighter jets so that repairs could be made by “an average mechanic *in the field under combat conditions* ...”.

While we aren’t designing fighter jets, our industry is jointly developing new rules that will guide our equity markets both in normal times *and in the heat of battle*, as times of market stress and high volatility are a natural and reoccurring part of any securities market.

Along with the SEC, FINRA, and the other equity, options, and futures exchanges, new rules have been (and continue to be) crafted that relate to individual stock circuit breakers, clearly erroneous executions, the limit-up / limit-down proposal, elimination of “stub quotes”, and planned revisions to the market-wide circuit breakers. These areas are rightly being addressed in response to the events during the financial crisis of 2008 and the events of May 6, 2010. Much progress has been made and the results so far are encouraging. And no doubt, other regulatory initiatives will follow.

The challenge, however, is keeping the many disparate rules simple, consistent, and easy to remember, and *therefore easy to execute*. There are several key parameters such as threshold percentages, prescribed time frames and limits, reference prices

(open, close, last five minutes, etc), applicable times of the day, and so on. These elements should not vary from rule to rule or from market to market any more than absolutely necessary to achieve the best overall results. Our collective customers will demand deterministic behaviors in the trading centers where they send their orders, and as a group of competing venues, we need to be able to execute according to the rules accurately, consistently, and quickly. Hence, a guiding principle for all of the new rules should be to “Keep it simple, Stupid!”

As these rules make their way through the brainstorming, straw-man, draft, and final language stages, we need to take time to look back at the many rules recently put into effect as well as potential new rules yet to come. We need to make sure that, collectively, they can be recalled clearly and accurately, and then implemented when it counts, especially in the heat of battle. Harmonizing the implementations between the many rules and asset classes will be key to achieving the goal of improving our capital markets and increasing customer confidence.

As always, your comments and feedback are welcome.

Sincerely,
Joe Ratterman

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