100 F Street NE., Washington, DC 20549–1090.

All submissions should refer to File Number SR–Phlx–2012–88. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml).* Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–Phlx–2012–88 and should be submitted on or before August 7, 2012.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[13]

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2012–17326 Filed 7–16–12; 8:45 am]

BILLING CODE 8011–01–P

[13] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–67411; File Nos. SR–NASDAQ–2012–043; SR–NYSEArca–2012–37]

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; NYSE Arca, Inc.; Order Instituting Proceedings To Determine Whether To Approve or Disapprove Proposed Rule Changes Relating to Market Maker Incentive Programs for Certain Exchange-Traded Products

July 11, 2012.

I. Introduction

On March 23, 2012, The NASDAQ Stock Market LLC (''NASDAQ'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'' or ''Exchange Act'') [1] and Rule 19b–4 thereunder,[2] a proposed rule change (''NASDAQ Proposal'') to establish the Market Quality Program (''MQP''). On March 29, 2012, NASDAQ submitted Amendment No. 1 to the proposed rule change.[3] The proposed rule change, as modified by Amendment No. 1 thereto, was published for comment in the **Federal Register** on April 12, 2012.[4] The Commission initially received fifteen comment letters on the NASDAQ Proposal.[5] On May 18, 2012, pursuant to Section 19(b)(2) of the Act,[6] the Commission designated a longer period within which to either approve the NASDAQ Proposal, disapprove the NASDAQ Proposal, or institute proceedings to determine whether to disapprove the NASDAQ Proposal.[7] The Commission received three additional comment letters on the NASDAQ Proposal.[8] On July 6, 2012, the Commission received NASDAQ's response to the comment letters.[9]

On April 27, 2012, NYSE Arca, Inc. (''NYSE Arca'' and together with NASDAQ, the ''Exchanges'') filed with the Commission, pursuant to Section 19(b)(1) of the Act [10] and Rule 19b–4 thereunder,[11] a proposed rule change (''NYSE Arca Proposal,'' and together with the NASDAQ Proposal, the ''SRO Proposals'') to create and implement, on a pilot basis, a Lead Market Maker (''LMM'') Issuer Incentive Program (''Fixed Incentive Program,'' and together with the MQP, the ''Programs'') for issuers of certain exchange-traded products listed on NYSE Arca. The NYSE Arca Proposal was published for comment in the **Federal Register** on May 17, 2012.[12] The Commission received two comment letters on the NYSE Arca Proposal.[13] On June 20, 2012, pursuant to Section 19(b)(2) of the Act,[14] the Commission designated a longer period within which to either approve the NYSE Arca Proposal, disapprove the NYSE Arca Proposal, or institute proceedings to determine whether to disapprove the NYSE Arca

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] In Amendment No. 1, NASDAQ made a technical amendment to Item I of Exhibit 1 to delete an erroneous reference to the NASDAQ Options Market and replace it with a reference to NASDAQ.

[4] Securities Exchange Act Release No. 66765 (April 6, 2012), 77 FR 22042 (''NASDAQ Notice'').

[5] *See* Letter from Frank Choi, dated April 13, 2012 (''Choi Letter''); Letter from Christopher J. Csicsko, dated April 14, 2012 (''Csicsko Letter''); Letter from Jeremiah O'Connor III, dated April 14, 2012 (''O'Connor Letter''); Letter from Dezso J. Szalay, dated April 15, 2012 (''Szalay Letter''); Letter from Kathryn Keita, dated April 18, 2012; Letter (''Keita Letter''); Letter from Anonymous, dated April 18, 2012 (''Anonymous Letter''); Letter from Mark Connell, dated April 19, 2012 (''Connell Letter''); Letter from Timothy Quast, Managing Director, Modern Networks IR LLC, dated April 26, 2012 (''IR Letter''); Letter from Daniel G. Weaver, Ph.D., Professor of Finance, Rutgers Business School, dated April 26, 2012 (''Weaver Letter''); Letter from Amber Anand, Associate Professor of Finance, Syracuse University, dated April 29, 2012 (''Anand Letter''); Letter from Albert J. Menkveld, Associate Professor of Finance, VU University Amsterdam, dated May 2, 2012 (''Menkveld Letter''); Letter from James J. Angel, Associate Professor of Finance, Georgetown University, dated May 2, 2012 (''Angel Letter''); Letter from Ari Burstein, Senior Counsel, Investment Company Institute, dated May 3, 2012 (''NASDAQ ICI Letter''); Letter from Gus Sauter, Managing Director and Chief Investment Officer, Vanguard, dated May 3, 2012 (''NASDAQ Vanguard Letter''); and Letter from Leonard J. Amoruso, General Counsel, Knight Capital Group, Inc., dated May 4, 2012 (''Knight Letter'').

[6] 15 U.S.C. 78s(b)(2).

[7] Securities Exchange Act Release No. 67022 (May 18, 2012), 77 FR 31050 (May 24, 2012). The Commission determined that it was appropriate to designate a longer period within which to take action on the NASDAQ Proposal so that it has sufficient time to consider the NASDAQ Proposal, the comments received, and any response to the comments submitted by NASDAQ. Accordingly, the Commission designated July 11, 2012 as the date by which it should either approve, disapprove, or institute proceedings to determine whether to disapprove the NASDAQ Proposal.

[8] *See* Letter from Gary L. Gastineau, Managing Member, ETF Consultants LLC, dated June 11, 2012 (''ETF Consultants Letter''); Letter from Rey Ramsey, President & CEO, TechNet, dated June 20, 2012 (''TechNet Letter''); and Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association, dated July 3, 2012 (''MFA Letter'').

[9] *See* Letter from Joan C. Conley, Senior Vice President & Corporate Secretary, NASDAQ, dated July 6, 2012 (''NASDAQ Response Letter'').

[10] 15 U.S.C. 78s(b)(1).

[11] 17 CFR 240.19b–4.

[12] Securities Exchange Act Release No. 66966 (May 11, 2012), 77 FR 29419 (''NYSE Arca Notice'').

[13] *See* Letter from Gus Sauter, Managing Director and Chief Investment Officer, Vanguard, dated June 7, 2012 (''NYSE Arca Vanguard Letter''); and Letter from Ari Burstein, Senior Counsel, Investment Company Institute, dated June 7, 2012 (''NYSE Arca ICI Letter'').

[14] 15 U.S.C. 78s(b)(2).

Proposal.[15] The Commission received one additional comment letter on the NYSE Arca Proposal.[16]

This order institutes proceedings under Section 19(b)(2)(B) of the Act to determine whether to approve or disapprove the SRO Proposals. Institution of these proceedings, however, does not indicate that the Commission has reached any conclusions with respect to the SRO Proposals, nor does it mean that the Commission will ultimately disapprove the SRO Proposals. Rather, as addressed below, the Commission desires to solicit additional input from interested parties on the issues presented by the SRO Proposals.

II. Description of the SRO Proposals

In the SRO Proposals, each of NASDAQ and NYSE Arca separately propose to adopt listing fees and related market maker incentive programs for certain securities on a pilot basis, as further described below.

A. NASDAQ Proposal

As set forth in more detail in the NASDAQ Notice,[17] NASDAQ is proposing to amend its rules to add new NASDAQ Rule 5950 (Market Quality Program) to establish an MQP listing fee and related market maker incentive program, and to adopt new IM–2460–1 to exempt the MQP from NASDAQ Rule 2460 (Payment for Market Making), on a pilot basis. The MQP would be a voluntary program and participation in the program would be at the discretion of each MQP Company (as defined below), subject to the requirements set forth in the proposed rule.

1. Proposed NASDAQ Rule 5950 (Market Quality Program)

The proposed MQP would be a program designed to promote market quality in certain securities listed on NASDAQ (''MQP Securities'') on a voluntary basis.[18] MQP Securities may include Exchange Traded Funds (''ETFs''), Linked Securities (''LS''), and Trust Issued Receipts (''TIRs'') listed on NASDAQ pursuant to NASDAQ Rules 5705, 5710, and 5720, respectively.[19] An ''MQP Company''[20] that lists an eligible MQP Security on NASDAQ would pay a listing fee as set forth in proposed NASDAQ Rule 5950 (''MQP Fee''), in addition to the standard (non-MQP) NASDAQ listing fee applicable to such MQP Security as set forth in the NASDAQ Rule 5000 Series (consisting of NASDAQ Rules 5000–5999).[21] NASDAQ represents that an MQP Fee would be used for the purpose of incentivizing one or more Market Makers[22] in the MQP Security (''MQP Market Maker'') to enhance the market quality of the MQP Security. Subject to the conditions set forth in the proposed rule, this incentive payment would be credited (''MQP Credit'') to one or more MQP Market Makers that make a quality market in the MQP Security pursuant to the MQP.[23]

a. Application and Withdrawal

An MQP Company that wants to have its MQP Security participate in the MQP, and a Market Maker that wants to participate in the MQP, would be required to each submit an application in the form prescribed by NASDAQ.[24] NASDAQ could, on a program-wide basis, limit the number of MQP Securities that any one MQP Company may list in the MQP.[25] In determining whether to limit the number of MQP Securities in the MQP, NASDAQ would consider all relevant information, including whether a restriction, if any, is in the best interest of NASDAQ, the MQP Company and the goals of the MQP, and investors.[26] NASDAQ could also, on a program-wide basis, limit the number of MQP Market Makers permitted to register in an MQP Security.[27] If such a limit were established, NASDAQ would allocate available MQP Market Maker registrations in a first-come-first-served fashion based on successful completion of an MQP Market Maker application.[28]

NASDAQ would provide notification on its Web site regarding: (i) The acceptance of an MQP Company and an MQP Market Maker into the MQP; (ii) the total number of MQP Securities that any one MQP Company may have in the MQP; (iii) the names of MQP Securities and the MQP Market Maker(s) in each MQP Security; and (iv) any limits on the number of MQP Market Makers permitted to register in an MQP Security.[29]

After an MQP Company is in the MQP for not less than two consecutive quarters but less than one year, it could voluntarily withdraw from the MQP on a quarterly basis.[30] The MQP Company would be required to notify NASDAQ in writing not less than one month prior to withdrawing from the MQP. Notwithstanding, NASDAQ could determine to allow an MQP Company to withdraw from the MQP earlier.[31] In making this determination, NASDAQ would take into account the volume and price movements in the MQP Security; the liquidity, size quoted, and quality of the market in the MQP Security; and any other relevant factors.[32] After an

[15] Securities Exchange Act Release No. 67222 (June 20, 2012), 77 FR 38116 (June 26, 2012). The Commission determined that it was appropriate to designate a longer period within which to take action on the NYSE Arca Proposal so that it has sufficient time to consider the NYSE Arca Proposal, the comments received, and any response to the comments submitted by NYSE Arca. Accordingly, the Commission designated August 15, 2012 as the date by which it should either approve, disapprove, or institute proceedings to determine whether to disapprove the NYSE Arca Proposal.

[16] *See* Letter from John T. Hyland, CFA, Chief Investment Officer, United States Commodity Funds LLC, dated June 27, 2012 (''USCF Letter'').

[17] *See supra* note 4.

[18] *See* proposed NASDAQ Rule 5950 Preamble. NASDAQ notes that MQP Securities do not encompass derivatives on such securities. *See* NASDAQ Notice, *supra* note 4, at 22043.

[19] *See* proposed NASDAQ Rule 5950(e)(1). The term ''Exchange Traded Fund'' includes Portfolio Depository Receipts and Index Fund Shares, which are defined in NASDAQ Rule 5705; the term ''Linked Security'' has the meaning given in NASDAQ Rule 5710; and the term ''Trust Issued Receipt'' has the meaning given in NASDAQ Rule 5720. *See* proposed NASDAQ Rules 5950(e)(2)–(4). NASDAQ notes that it believes that MQP Securities would predominantly, if not entirely, consist of ETFs. *See* NASDAQ Notice, *supra* note 4, at 22043.

[20] The term ''MQP Company'' is defined as a fund sponsor or other entity that lists one or more MQP Securities on NASDAQ pursuant to the MQP. *See* proposed NASDAQ Rule 5950(e)(7).

[21] *See* proposed NASDAQ Rule 5950 Preamble. The NASDAQ Rule 5000 Series contains rules related to the qualification, listing, and delisting of Companies on the NASDAQ Stock Market. The NASDAQ Rule 5100 Series discusses NASDAQ's general regulatory authority. The NASDAQ Rule 5200 Series sets forth the procedures and prerequisites for gaining a listing on the NASDAQ Stock Market, as well as the disclosure obligations of listed Companies. The NASDAQ Rule 5300, 5400, and 5500 Series contain the specific quantitative listing requirements for listing on the Global Select, Global Market, and Capital Market, respectively. The corporate governance requirements applicable to all Companies are contained in the NASDAQ Rule 5600 Series. Special listing requirements for securities other than common or preferred stock and warrants are contained in the NASDAQ Rule 5700 Series. The consequences of a failure to meet NASDAQ's listing standards are contained in the NASDAQ Rule 5800 Series. Listing fees are described in the NASDAQ Rule 5900 Series. The term ''Company'' is defined in NASDAQ Rule 5005(a)(6) as the issuer of a security listed or applying to list on NASDAQ, and may include an issuer that is not incorporated, such as, for example, a limited partnership.

[22] The term ''Market Maker'' has the meaning given in NASDAQ Rule 5005(a)(24). *See* proposed NASDAQ Rule 5950(e)(5).

[23] *See* proposed NASDAQ Rule 5950 Preamble.

[24] *See* proposed NASDAQ Rule 5950(a)(1).

[25] *See* proposed NASDAQ Rule 5950(a)(1)(A).

[26] *See* proposed NASDAQ Rule 5950(a)(1)(B). Factors that could be considered by NASDAQ include, but are not limited to, the current and expected liquidity characteristics of MQP Securities; the projected initial and continuing market quality needs of MQP Securities; and the trading characteristics of MQP Securities (*e.g.,* quoting, trading, and volume). *See* proposed NASDAQ Rule 5950(a)(1)(B)(i).

[27] *See* proposed NASDAQ Rule 5950(c)(3).

[28] *See* proposed NASDAQ Rule 5950(c)(3)(A).

[29] *See* proposed NASDAQ Rule 5950(a)(1)(C) and proposed NASDAQ Rule 5950(c)(3).

[30] *See* proposed NASDAQ Rule 5950(a)(2)(A).

[31] *Id.*

[32] *Id.*

MQP Company is in the MQP for one year or more, it could voluntarily withdraw from the MQP on a monthly basis, and would be required to notify NASDAQ in writing not less than one month prior to withdrawing from the MQP.[33] After an MQP Company is in the MQP for one year, the MQP and all obligations and requirements of the MQP would automatically continue on an annual basis, unless NASDAQ terminates the MQP by providing not less than one month prior notice of intent to terminate; the MQP Company withdraws from the MQP pursuant to the proposed rule; or the MQP Company is terminated from the MQP pursuant to proposed NASDAQ Rule 5950(d).[34]

After an MQP Market Maker is in the MQP for not less than one quarter, the MQP Market Maker could withdraw from the MQP on a quarterly basis. The MQP Market Maker would be required to notify NASDAQ in writing one month prior to withdrawing from the MQP.[35]

b. MQP Company Eligibility and Fee Liability

For an MQP Company to be eligible to have its MQP Security participate in the MQP, the following conditions would be required to be satisfied: (i) NASDAQ must have accepted the MQP Company's application in respect of such MQP Security, and must have accepted the application of at least one MQP Market Maker in the same MQP Security; (ii) the MQP Security must meet all requirements to be listed on NASDAQ as an ETF, LS, or TIR; and (iii) the MQP Security must meet all NASDAQ requirements for continued listing at all times the MQP Security participates in the MQP.[36]

An MQP Company participating in the MQP would be required to pay to NASDAQ an annual basic MQP Fee of $50,000 per MQP Security (''Basic MQP Fee''), which fee would be required to be paid in quarterly installments as billed by NASDAQ.[37] The Basic MQP Fee, which would fund the MQP Credit to be paid to the eligible MQP Market Maker(s), would be allocated 50% toward funding the ''Quote Share Payment'' and 50% toward funding the ''Trade Share Payment.''[38] Quote Share Payments would be based in equal proportions on: (i) Average quoted size at or better than NBBO; and (ii) average time spent quoting at or better than NBBO.[39] Trade Share Payments would be based upon each MQP Market Maker's share of total Qualified Trades in an MQP Security executed on the NASDAQ Market Center.[40]

An MQP Company could also pay an annual supplemental MQP Fee per MQP Security (''Supplemental MQP Fee''), which would also fund the MQP Credit to be paid to the eligible MQP Market Maker(s) and would be required to be paid in quarterly installments as billed by NASDAQ.[41] The Basic MQP Fee and Supplemental MQP Fee when combined could not exceed $100,000 per year.[42] The amount of the Supplemental MQP Fee, if any, would be determined by the MQP Company on an annual basis.[43] An MQP Company would be required to indicate the proportions between 0% and 100% in which the Supplemental MQP Fee would be allocated to the Quote Share Payment and/or the Trade Share Payment.[44] NASDAQ would provide notification on its Web site regarding the amount, if any, of any Supplemental MQP Fee and the Quote Share Payment/Trade Share Payment allocation determined by an MQP Company.[45]

The Basic MQP Fee and Supplemental MQP Fee, if any, would be in addition to the standard (non-MQP) NASDAQ listing fee applicable to the MQP Security and would not offset such standard listing fee.[46] At the beginning of a quarter, NASDAQ would bill each MQP Company for the quarterly portion of an MQP Company's Basic MQP Fee and Supplemental MQP Fee, if any, for each MQP Security, and each quarterly bill would be based on the MQP Credit earned by the MQP Market Maker(s) in each MQP Security for the immediately preceding quarter.[47] All revenue from the Basic MQP Fee and the Supplemental MQP Fee would be credited pro rata to the eligible MQP Market Maker(s) in an MQP Security, and any portion of an MQP Fee that is not credited to eligible MQP Market Makers would be refunded to the MQP Company.[48]

c. MQP Market Maker Eligibility and MQP Credit Distribution

For a Market Maker to be eligible to participate in the MQP, NASDAQ must have accepted such Market Maker's application in respect of an MQP Security and must have accepted the application of the MQP Company in respect of the same MQP Security.[49] In addition, to be eligible to receive a periodic MQP Credit, MQP Market Makers must, when making markets in an MQP Security, meet the applicable Market Maker obligations pursuant to NASDAQ Rule 4613,[50] and must also meet or exceed the following requirements on a monthly basis with respect to an MQP Security: (i) For at least 25% of the time when quotes can be entered in the Regular Market

[33] *See* proposed NASDAQ Rule 5950(a)(2)(B).

[34] *See* proposed NASDAQ Rule 5950(a)(3). Proposed NASDAQ Rule 5950(d) states, in part, that the MQP would terminate in respect of an MQP Security under the following circumstances: (A) An MQP Security sustains an average NASDAQ daily trading volume of two million shares or more for three consecutive months; (B) an MQP Company withdraws from the MQP, is no longer eligible to be in the MQP pursuant to the proposed rule, or ceases to make MQP fee payments to NASDAQ; (C) an MQP Security is delisted or is no longer eligible for the MQP; (D) an MQP Security does not have at least one MQP Market Maker for more than one quarter; or (E) an MQP Security does not, for two consecutive quarters, have at least one MQP Market Maker that is eligible for the MQP Credit.

[35] *See* proposed NASDAQ Rule 5950(a)(2)(C).

[36] *See* proposed NASDAQ Rule 5950(b)(1).

[37] *See* proposed NASDAQ Rule 5950(b)(2)(A).

[38] *See* proposed NASDAQ Rule 5950(b)(2)(A)(i). Each MQP Credit to be paid to the eligible MQP Market Maker(s) would be comprised of a ''Quote Share Payment'' that is based on Qualified Quotes, and a ''Trade Share Payment'' that is based on Qualified Trades. *See* proposed NASDAQ Rule 5950(c)(2)(A). A ''Qualified Quote'' represents attributable and displayed liquidity (either quotes or orders) entered by an MQP Market Maker in an MQP Security that is posted within 2% of the National Best Bid or Offer (''NBBO''). *See* proposed NASDAQ Rule 5950(c)(2)(A)(i). A ''Qualified Trade'' represents a liquidity-providing execution of a Qualified Quote on the NASDAQ Market Center. *See* proposed NASDAQ Rule 5950(c)(2)(A)(ii).

[39] *See* proposed NASDAQ Rule 5950(c)(2)(B)(ii).

[40] *See* proposed NASDAQ Rule 5950(c)(2)(B)(i).

[41] *See* proposed NASDAQ Rule 5950(b)(2)(B).

[42] *Id.*

[43] *See* proposed NASDAQ Rule 5950(b)(2)(B)(i).

[44] *See* proposed NASDAQ Rule 5950(b)(2)(B)(ii).

[45] *See* proposed NASDAQ Rule 5950(b)(2)(B)(iii).

[46] *See* proposed NASDAQ Rule 5950(b)(2)(C).

[47] *See* proposed NASDAQ Rule 5950(b)(2)(D).

[48] *See* proposed NASDAQ Rule 5950(b)(2)(E).

[49] *See* proposed NASDAQ Rule 5950(c)(1)(A). NASDAQ could also accept the MQP applications of multiple MQP Market Makers in the same MQP Security, subject to any limitation on the number of MQP Market Makers established pursuant to the proposed rule. *Id.*

[50] NASDAQ Rule 4613 states that market making obligations applicable to NASDAQ members that are registered as Market Makers include, among other things, quotation requirements and obligations as follows: For each security in which a member is registered as a Market Maker, the member shall be willing to buy and sell such security for its own account on a continuous basis during regular market hours and shall enter and maintain a two-sided trading interest (''Two-Sided Obligation'') that is identified to NASDAQ as the interest meeting the obligation and is displayed in NASDAQ's quotation montage at all times. Interest eligible to be considered as part of a Market Maker's Two-Sided Obligation shall have a displayed quotation size of at least one normal unit of trading (or a larger multiple thereof); provided, however, that a Market Maker may augment its Two-Sided Obligation size to display limit orders priced at the same price as the Two-Sided Obligation. Unless otherwise designated, a ''normal unit of trading'' shall be 100 shares. After an execution against its Two-Sided Obligation, a Market Maker must ensure that additional trading interest exists in NASDAQ to satisfy its Two-Sided Obligation either by immediately entering new interest to comply with this obligation to maintain continuous two-sided quotations or by identifying existing interest on the NASDAQ book that will satisfy this obligation.

Session [51] as averaged over the course of a month, maintain at least 500 shares of attributable, displayed quotes or orders at the National Best Bid (''NBB'') or better, and at least 500 shares of attributable, displayed quotes or orders at the National Best Offer (''NBO'') or better; and (ii) for at least 90% of the time when quotes can be entered in the Regular Market Session as averaged over the course of a month, maintain at least 2,500 shares of attributable, displayed posted liquidity on the NASDAQ Market Center [52] that are priced no wider than 2% away from the NBB, and at least 2,500 shares of attributable, displayed posted liquidity on the NASDAQ Market Center that are priced no wider than 2% away from the NBO.[53]

MQP Credits for each MQP Security would be calculated monthly and credited quarterly on a pro rata basis to one or more eligible MQP Market Makers.[54] As described above, each MQP Credit would be comprised of a ''Quote Share Payment'' that is based on Qualified Quotes, and a ''Trade Share Payment'' that is based on Qualified Trades.[55] Quote Share Payments and Trade Share Payments would be funded by Basic MQP Fees and Supplemental MQP Fees, if any.[56]

An MQP Credit would be credited quarterly to an MQP Market Maker on a pro rata basis for each month during such quarter that an MQP Market Maker is eligible to receive a credit pursuant to the proposed rule.[57] The calculation to establish the eligibility of an MQP Market Maker would be done on a monthly basis.[58]

d. Termination of MQP

The MQP would terminate in respect of an MQP Security under any of the following circumstances: (i) Such MQP Security sustains an average NASDAQ daily trading volume (''ATV'') of 2,000,000 shares or more for three consecutive months; (ii) an MQP Company withdraws such MQP Security from the MQP, is no longer eligible to be in the MQP, or ceases to make MQP Fee payments to NASDAQ; (iii) such MQP Security is delisted or is no longer eligible for the MQP; (iv) such MQP Security does not have at least one MQP Market Maker for more than one quarter; or (v) such MQP Security does not, for two consecutive quarters, have at least one MQP Market Maker that is eligible for MQP Credit.[59] Any MQP Credits remaining upon termination of the MQP in respect of an MQP Security would be distributed on a pro rata basis to the MQP Market Makers that made a market in such MQP Security and were eligible to receive MQP Credits pursuant to the proposed rule, or, if no MQP Market Makers qualify, refunded to the MQP Company.[60] Termination of an MQP Company, MQP Security, or MQP Market Maker would not preclude NASDAQ from allowing re-entry into the MQP where NASDAQ deems proper.[61]

e. Pilot Basis

As proposed, the MQP would be effective for a one-year pilot period that would commence when the MQP is implemented by NASDAQ's acceptance of an MQP Company and relevant MQP Market Maker into the MQP and would end one year after implementation.[62]

During the pilot period, NASDAQ would periodically provide information to the Commission about market quality in respect of the MQP. Specifically, NASDAQ would submit monthly reports to the Commission about market quality in respect of the MQP, which reports would endeavor to compare, to the extent practicable, securities before and after they are in the MQP, and would include information regarding the MQP such as: (i) Rule 605 metrics; [63] (ii) volume metrics; (iii) number of MQP Market Makers; (iv) spread size; and (v) availability of shares at the NBBO.[64] The first report would be submitted within sixty days after the MQP becomes operative.[65]

2. Proposed IM–2460–1 Market Quality Program

As part of its proposal to establish the MQP by adding new NASDAQ Rule 5950, NASDAQ is proposing to amend NASDAQ Rule 2460 (Payments for Market Making), which prohibits direct or indirect payment by an issuer to a Market Maker, to adopt a new interpretive provision to the rule.[66] Specifically, NASDAQ is proposing to adopt new IM–2460–1 (Market Quality Program) to provide that NASDAQ Rule 2460 would not be applicable to a member that is accepted into the MQP pursuant to proposed NASDAQ Rule 5950 or to a person that is associated with such member for their conduct in connection with the MQP.[67]

3. Surveillance

NASDAQ represents that its surveillance procedures are adequate to properly monitor the trading of the MQP Securities on NASDAQ during all trading sessions, and to detect and deter violations of NASDAQ rules and applicable federal securities laws. Trading of the MQP Securities through NASDAQ would be subject to FINRA's surveillance procedures for derivative

[51] The term ''Regular Market Session'' has the meaning given in NASDAQ Rule 4120(b)(4)(D). *See* proposed NASDAQ Rule 5950(e)(8).

[52] The term ''NASDAQ Market Center'' has the meaning given in NASDAQ Rule 4751(a). *See* proposed NASDAQ Rule 5950(e)(6).

[53] *See* proposed NASDAQ Rule 5950(c)(1)(B). NASDAQ provides the following examples to illustrate these market quality requirements:

Regarding the first market quality standard (25%), in an MQP Security where the NBBO is $25.00 × $25.10, for a minimum of 25% of the time when quotes can be entered in the Regular Market Session as averaged over the course of a month, an MQP Market Maker must maintain bids at or better than $25.00 for at least 500 shares and must maintain offers at or better than $25.10 for at least 500 shares. Thus, if there were 20 trading days in a given month and the MQP Market Maker met this requirement 20% of the time when quotes can be entered in the Regular Market Session for 10 trading sessions and 40% of the time when quotes can be entered in the Regular Market Session for 10 trading sessions then the MQP Market Maker would have met the requirement 30% of the time in that month.

Regarding the second market quality standard (90%), in an MQP Security where the NBBO is $25.00 × $25.10, for a minimum of 90% of the time when quotes can be entered in the Regular Market Session as averaged over the course of a month, an MQP Market Maker must post bids for an aggregate of 2,500 shares between $24.50 and $25.00, and post offers for an aggregate of 2,500 shares between $25.10 and $25.60. Thus, if there were 20 trading days in a given month and the MQP Market Maker met this requirement 88% of the time when quotes can be entered in the Regular Market Session for 10 trading sessions and 98% of the time when quotes can be entered in the Regular Market Session for 10 trading sessions then the MQP Market Maker would have met the requirement 93% of the time in that month.

See NASDAQ Notice, *supra* note 4, at 22049.

[54] *See* proposed NASDAQ Rule 5950(c)(2).

[55] *See supra* notes 38–40 and accompanying text.

[56] *See* proposed NASDAQ Rule 5950(c)(2)(B)(iii).

[57] *See* proposed NASDAQ Rule 5950(c)(2)(C).

[58] *Id.* For example, if during a quarter an MQP Market Maker was eligible to receive a credit for two out of three months, such MQP Market Maker would receive a quarterly pro rata MQP Credit for those two months. *See* NASDAQ Notice, *supra* note 4, at 22049.

[59] *See* proposed NASDAQ Rule 5950(d)(1).

[60] *See* proposed NASDAQ Rule 5950(d)(2).

[61] *See* proposed NASDAQ Rule 5950(d)(3).

[62] *See* proposed NASDAQ Rule 5950(f).

[63] 17 CFR 242.605.

[64] *See* NASDAQ Notice, *supra* note 4, at 22049.

[65] *Id.*

[66] In relevant part, NASDAQ Rule 2460 provides that ''[n]o member or person associated with a member shall accept any payment or other consideration, directly or indirectly, from an issuer of a security, or any affiliate or promoter thereof, for publishing a quotation, acting as market maker in a security, or submitting an application in connection therewith.''

[67] *See* proposed IM–2460–1. NASDAQ notes that, based on discussions with the Financial Industry Regulatory Authority (''FINRA''), it expects FINRA to file a proposed rule change to exempt the MQP from FINRA Rule 5250. *See* NASDAQ Notice, *supra* note 4, at 22042. Similar to NASDAQ Rule 2460, FINRA Rule 5250 (formerly NASD Rule 2460) prohibits FINRA members from directly or indirectly accepting payment from an issuer of a security for acting as a market maker. *See* Securities Exchange Act Release No. 38812 (July 3, 1997), 62 FR 37105 (July 10, 1997) (SR–NASD–97–29) (''NASD Rule 2460 Approval Order'').

products including ETFs.[68] NASDAQ may obtain information via the Intermarket Surveillance Group (''ISG'') from other exchanges that are members or affiliates of ISG and from listed MQP Companies and public and non-public data sources such as, for example, Bloomberg.

B. NYSE Arca Proposal

As set forth in more detail in the NYSE Arca Notice,[69] NYSE Arca proposes to adopt new NYSE Arca Equities Rule 8.800 to establish and implement, on a pilot basis, the Fixed Incentive Program for issuers of certain exchange-traded products (''ETPs'') listed on NYSE Arca, to incentivize Market Makers to undertake LMM assignments in ETPs. Pursuant to the NYSE Arca Proposal, an issuer of an ETP that participates in the proposed Fixed Incentive Program would elect to pay an ''Optional Incentive Fee'' to NYSE Arca, in an amount ranging from $10,000 to $40,000 per year,[70] and, subject to the requirements set forth in the proposed rule, a Market Maker accepting an LMM assignment in an ETP in the Fixed Incentive Program would receive a payment from NYSE Arca (''LMM Payment'') in an amount equal to the Optional Incentive Fee, less a 5% NYSE Arca administration fee. The NYSE Arca Proposal would not alter the current requirements and obligations of LMMs under NYSE Arca rules or any policies and procedures related to LMMs.[71]

1. Proposed NYSE Arca Equities Rule 8.800 (Terms of Fixed Incentive Program)

a. Eligibility for the Fixed Incentive Program

An ETP would be eligible to participate in the Fixed Incentive Program if it is listed on NYSE Arca as of the commencement of the pilot period or becomes listed during the pilot period, and the listing is under NYSE Arca Equities Rules 5.2(j)(3) (Investment Company Units), 5.2(j)(5) (Equity Gold Shares), 5.2(j)(6) (Equity Index-Linked Securities, Commodity-Linked Securities, Currency-Linked Securities, Fixed Income Index-Linked Securities, Futures-Linked Securities and Multifactor Index-Linked Securities), 8.100 (Portfolio Depositary Receipts), 8.200 (Trust Issued Receipts), 8.201 (Commodity-Based Trust Shares), 8.202 (Currency Trust Shares), 8.203 (Commodity Index Trust Shares), 8.204 (Commodity Futures Trust Shares), 8.300 (Partnership Units), 8.600 (Managed Fund Shares), or 8.700 (Managed Trust Securities).[72]

To be eligible to participate in the Fixed Incentive Program, an issuer would be required to be current in all payments due to NYSE Arca if it had other securities listed on NYSE Arca.[73] In addition, the issuer would be required to be current in all payments due to NYSE Arca and to be compliant with continuing listing standards for the ETP proposed for inclusion if the issuer elected to participate in the Fixed Incentive Program after listing such ETP on NYSE Arca.[74]

b. Application and Withdrawal

An issuer that wishes to have an ETP participate in the Fixed Incentive Program would be required to submit a written application in a form prescribed by NYSE Arca for each ETP.[75] An issuer would not be permitted to have more than five existing ETPs (ETPs that are listed on NYSE Arca prior to the pilot) participate in the Fixed Incentive Program.[76] NYSE Arca would communicate the ETPs proposed for inclusion in the Fixed Incentive Program on a written solicitation that is sent to all qualified LMM firms along with the Optional Incentive Fee the issuer proposes to pay for each ETP.[77] The permitted range for the Optional Incentive Fee would be set forth in the Exchange's Fee Schedule, and, as proposed, would be between $10,000 and $40,000 per year.[78] The issuer and the LMM thereafter would agree upon the final Optional Incentive Fee for each ETP.[79] If more than one qualified LMM proposed to serve as such, the issuer would choose the LMM.[80] NYSE Arca would provide notification on its Web site regarding the ETPs participating in the Fixed Incentive Program and the assigned LMMs.[81]

If an ETP no longer meets continuing listing standards or is being liquidated, it would be automatically withdrawn from the Fixed Incentive Program as of the ETP suspension date.[82]

NYSE Arca, in its discretion, could allow an issuer to withdraw an ETP from the Fixed Incentive Program before the end of the pilot if the assigned LMM is unable to meet its minimum performance standards for two of the three months of a quarter or for five months during the pilot and no other qualified Equity Trading Permit Holder is able to take over the assignment to become the new LMM for the ETP.[83]

An LMM could withdraw from all of its ETP assignments in the Fixed Incentive Program.[84] Furthermore, NYSE Arca, in its discretion, could allow an LMM to withdraw from a particular ETP before the end of the pilot period if NYSE Arca determines that there are extraneous circumstances that prevent the LMM from meeting its minimum performance standards for such ETP that do not affect its other ETP assignments in the Fixed Incentive Program.[85]

If the LMM for a particular ETP does not meet or exceed its minimum performance standards for any two of

[68] FINRA surveils trading on NASDAQ pursuant to a regulatory services agreement. NASDAQ is responsible for FINRA's performance under this regulatory services agreement.

[69] *See supra* note 12.

[70] An issuer of an ETP that participates in the proposed Fixed Incentive Program would continue to pay the currently applicable Listing and Annual Fees. Under the current Fee Schedule for listings, an issuer of an ETP is required to pay a Listing Fee that ranges from $5,000 to $45,000. ETP issuers also pay a graduated Annual Fee based on the number of shares of the ETP that are outstanding, which ranges $5,000 to $55,000. *See* NYSE Arca Notice, *supra* note 12, at 29419.

[71] *See* NYSE Arca Notice, *supra* note 12, at 29422. An LMM is subject to the obligations for Market Makers set forth in NYSE Arca Equities Rule 7.23 and the minimum performance standards that are referenced in NYSE Arca Equities Rule 7.24. Under NYSE Arca Equities Rule 7.24, the minimum performance standards include: (i) Percent of time at the NBBO; (ii) percent of executions better than the NBBO; (iii) average displayed size; (iv) average quoted spread; and (v) in the event the security is a derivative security, the ability to transact in underlying markets. An LMM's minimum performance standards are higher than those of a Designated Market Maker and are described in an official NYSE Arca policy titled *NYSE Arca LMM Requirements,* which may be amended from time to time. The minimum performance standards are measured daily and reviewed as a monthly average. *See id.* at 29420, n.5.

[72] *See* proposed NYSE Arca Equities Rule 8.800(a).

[73] *See* proposed NYSE Arca Equities Rule 8.800(b)(2).

[74] *See id.*

[75] *See* proposed NYSE Arca Equities Rule 8.800(b)(1). An issuer could elect to participate at the time of listing or thereafter at the beginning of each quarter during the pilot period. *See id.*

[76] *See id.*

[77] *See id.* The written solicitation would be included in the Green Sheet, which is the common term for an email communication sent by NYSE Arca staff members to all qualified LMMs prior to an LMM selection. The Green Sheet includes, among other things, the name, symbol, and description of the ETP(s) as well as the name of the issuer and a link to the ETP prospectus. A qualified LMM must complete the application for a specific ETP or group of ETPs. *See* NYSE Arca Notice, *supra* note 12, at 29421, n.11.

[78] *See id. See also* proposed amendment to NYSE Arca's Listing Fees Schedule (as defined below).

[79] *See* proposed NYSE Arca Equities Rule 8.800(b)(1).

[80] *See id.*

[81] *See* NYSE Arca Notice, *supra* note 12, at 29420, n.10.

[82] *See* proposed NYSE Arca Equities Rule 8.800(e)(1).

[83] *See* proposed NYSE Arca Equities Rule 8.800(e)(2).

[84] *See* proposed NYSE Arca Equities Rule 8.800(e)(3).

[85] *See id.*

the three months of a quarter or five months during the pilot, or chooses to withdraw from the Fixed Incentive Program (or from a particular ETP in the Fixed Incentive Program), and at least one other qualified Market Maker has agreed to become the assigned LMM under the Fixed Incentive Program, then the ETP would be reallocated and the issuer may select another LMM and renegotiate the Optional Incentive Fee in accordance with the solicitation process set forth in the proposed rule.[86]

c. Payment of Optional Incentive Fee

As discussed above, as proposed, the permitted range for the Optional Incentive Fee would be between 10,000 and 40,000 per year, and the issuer and the LMM assigned to an ETP would agree upon the final Optional Incentive Fee for each ETP. The Optional Incentive Fee for each ETP would be paid by the issuer to NYSE Arca in quarterly installments at the beginning of each quarter and prorated if the issuer commences participation in the Fixed Incentive Program for an ETP after the beginning of a quarter.[87] The issuer would receive a prorated credit from NYSE Arca following the end of the quarter if the LMM does not meet its minimum performance standards in any given month in such quarter for an ETP.[88] The credit would be applied against the issuer's next quarterly installment of the Optional Incentive Fee for the ETP, or otherwise credited or refunded to the issuer if the ETP is withdrawn from the Fixed Incentive Program.[89]

NYSE Arca would credit an LMM for the LMM Payment in an amount equal to the Optional Incentive Fee paid by the issuer, less a NYSE Arca administration fee set forth in the Fee Schedule, which, as proposed, would initially be 5%.[90] An LMM that receives an LMM Payment would not be eligible for the LMM transaction fees and credits set forth in the Trading Fee Schedule for such ETP while participating in the Fixed Incentive Program, but would instead be subject to the standard transaction fees and credits applicable to Equity Trading Permit Holders and Market Makers set forth in the Trading Fee Schedule for transactions in such ETP during that quarter.[91]

NYSE Arca would credit an LMM for the LMM Payment at the end of each quarter and, if an LMM does not meet or exceed its minimum performance standards for the ETP for a particular month, then the LMM Payment would be prorated accordingly.[92]

If an issuer does not pay its quarterly installments to NYSE Arca on time and the ETP continues to be listed, NYSE Arca would continue to credit the LMM in accordance with the proposed rule, except that after two quarters, if an issuer is not current in its quarterly installments for an ETP, such ETP would be automatically terminated from the Fixed Incentive Program.[93]

2. Proposed Amendments to Listing Fee Schedule and Trading Fee Schedule

To implement the Fixed Incentive Program, NYSE Arca also proposes to amend its Fee Schedules.[94] NYSE Arca proposes to amend its Listing Fee Schedule to provide that the Optional Incentive Fee under proposed NYSE Arca Equities Rule 8.800 may range from $10,000 to $40,000 per year. In addition, NYSE Arca proposes to amend its Trading Fee Schedule to provide that, in accordance with proposed NYSE Arca Equities Rule 8.800, at the end of each quarter, NYSE Arca would credit the LMM assigned to an ETP the Optional Incentive Fee, less a 5% NYSE Arca administration fee. NYSE Arca further proposes to amend its Trading Fee Schedule to provide that an LMM that receives an LMM Payment under proposed NYSE Arca Equities Rule 8.800 would be subject to the standard transaction fees and credits applicable to Equity Trading Permit Holders and Market Makers set forth in the Trading Fee Schedule for transactions in such ETP during that quarter, instead of the LMM transaction fees and credits set forth in the Trading Fee Schedule.[95]

3. Pilot Program

The Fixed Incentive Program would be implemented on a pilot basis and would be offered to issuers from the date of implementation, which would occur no later than 90 days after the effective date of the NYSE Arca Proposal, until December 31, 2013.[96] During the course of the pilot period, NYSE Arca would assess the terms of the Fixed Incentive Program and would submit a rule filing to the Commission as necessary if it determines that any of the terms should be changed. At the end of the pilot, NYSE Arca would determine whether to continue or discontinue the pilot or make it permanent and submit a rule filing to the Commission as necessary.[97]

During the pilot program, the Exchange would provide the Commission with certain market quality data on a confidential basis each month, including, for all ETPs listed as of the date of implementation of the pilot program and listed during the pilot (for comparative purposes), volume metrics, NBBO bid/ask spread differentials, LMM participation rates, NYSE Arca market share, LMM time spent at the inside, LMM time spent within $0.03 of the inside, percent of time NYSE Arca has the best price with the best size, LMM quoted spread, LMM quoted depth, and Rule 605 statistics (one-month delay).[98] In addition, NYSE Arca would provide such other data as may be periodically requested by the Commission.[99]

C. Comparison of the SRO Proposals

As further discussed below, the Commission received comments requesting that it consider the SRO Proposals together, to allow commenters to compare and contrast the different approaches and assist the Commission in considering the overall issues raised

[86] *See* proposed NYSE Arca Equities Rule 8.800(e)(4). The reallocation process would be required to be completed no sooner than the end of the current quarter and no later than the end of the following quarter. *See id.*

[87] *See* proposed NYSE Arca Equities Rule 8.800(c)(1).

[88] *See id.*

[89] *See id.*

[90] *See* proposed NYSE Arca Equities Rule 8.800(d)(1) and proposed amendment to NYSE Arca's Trading Fees Schedule (as defined below).

[91] *See* proposed NYSE Arca Equities Rule 8.800(d)(1). NYSE Arca generally employs a maker-taker transactional fee structure, whereby an Equity Trading Permit Holder that removes liquidity is charged a fee (''Take Rate''), and an Equity Trading Permit Holder that provides liquidity receives a credit (''Make Rate''). The Take Rate for LMMs is currently $0.0025 per share. The Make Rate for LMMs is currently between $0.0035 and $0.0045 per share depending on consolidated average daily volume. Standard NYSE Arca Tape B Make Rates (rebates paid for adding liquidity) range from $0.0022 to $0.0033 per share. Standard NYSE Arca Tape B Take Rates (fees charged for removing liquidity) range from $0.0026 to $0.0030 per share. *See* NYSE Arca Notice, *supra* note 12, at 29429, n.8.

[92] *See* proposed NYSE Arca Equities Rule 8.800(d)(2). LMM Payments would be paid directly by NYSE Arca from its general revenues. *See* NYSE Arca Notice, *supra* note 12, at 29421.

[93] *See* proposed NYSE Arca Equities Rule 8.800(c)(2).

[94] NYSE Arca has one Schedule of Fees and Charges for Exchange Services that is for listings (''Listing Fee Schedule'') and another that is for trade-related charges (''Trading Fee Schedule''). To differentiate them, NYSE Arca proposes to change the name of the former to ''SCHEDULE OF FEES AND CHARGES FOR EXCHANGE LISTING SERVICES.'' *See* NYSE Arca Notice, *supra* note 12 at 29422.

[95] *See supra* note 91 and accompanying text.

[96] *See* NYSE Arca Notice, *supra* note 12, at 29422.

[97] *See* NYSE Arca Notice, *supra* note 12, at 29422.

[98] *See id. See also* 17 CFR 242.605.

[99] *Id.* NYSE Arca notes that, based upon discussions with FINRA, subsequent to NYSE Arca's filing of the NYSE Arca Proposal, FINRA would file an immediately effective rule change indicating that participation by LMMs and issuers in the Fixed Incentive Program would not be prohibited by FINRA Rule 5250. *See* NYSE Arca Notice, *supra* note 12, at 29423, n.17.

by the SRO Proposals.[100] Both of the SRO Proposals would establish pilot programs that would allow issuers of certain types of securities to pay additional listing fees for additional liquidity services. In particular, issuers would make payments to the exchange that the exchange would then pay to a market maker(s) in that issuer's security. While there are a number of similarities between the SRO Proposals, there are also a number of differences between the two. Although not an exhaustive comparison, below is a summary of the more significant differences between the SRO Proposals:

- Under NASDAQ's proposed MQP, MQP Securities may include Exchange Traded Funds (''ETFs''), Linked Securities (''LS''), and Trust Issued Receipts (''TIRs'') listed on NASDAQ pursuant to NASDAQ Rules 5705, 5710, and 5720, respectively. Under NYSE Arca's proposal, an ETP would be eligible to participate in the Fixed Incentive Program if it is listed on NYSE Arca under NYSE Arca Equities Rules 5.2(j)(3) (Investment Company Units), 5.2(j)(5) (Equity Gold Shares), 5.2(j)(6) (Equity Index-Linked Securities, Commodity-Linked Securities, Currency-Linked Securities, Fixed Income Index-Linked Securities, Futures-Linked Securities and Multifactor Index-Linked Securities), 8.100 (Portfolio Depositary Receipts), 8.200 (Trust Issued Receipts), 8.201 (Commodity-Based Trust Shares), 8.202 (Currency Trust Shares), 8.203 (Commodity Index Trust Shares), 8.204 (Commodity Futures Trust Shares), 8.300 (Partnership Units), 8.600 (Managed Fund Shares), or 8.700 (Managed Trust Securities).
- Under NASDAQ's proposed MQP, only ETPs that have an ATV of less than 2,000,000 would be eligible for the MQP, and the MQP would terminate with respect to an MQP Security if the security obtains 2,000,000 ATV or greater for three consecutive months. There is no similar trading volume threshold for ETPs to be eligible to participate in NYSE Arca's proposed Fixed Incentive Program or that would trigger termination of such program.
- MQP Market Makers participating in NASDAQ's proposed MQP would be subject to higher performance standards than those applicable to Market Makers not participating in the MQP. Under NYSE Arca's proposed Fixed Incentive Program, participating LMMs would be subject to the same performance standards as LMMs not participating in the Fixed Incentive Program.
- Under NYSE Arca's proposed Fixed Incentive Program, only one market maker, the LMM, would be assigned to each ETP in the Fixed Incentive Program, and such LMM would receive the entire LMM Payment, provided it met the existing LMM performance standards. Under NASDAQ's proposed MPQ, multiple competing MQP Market Makers could be assigned to an MQP Security (although NASDAQ would retain discretion to restrict the number of MQP Market Makers in an MQP Security), and such MQP Market Makers would be compensated on a pro rata basis (provided they met the required performance standards) based upon Qualified Quotes and Qualified Trades.
- Pursuant to NASDAQ's proposed MQP, an MQP Company participating in the MQP would be required to pay a fixed Basic MQP Fee of $50,000, and, at its discretion, could choose to pay a Supplemental MQP Fee of up to an additional $50,000. The payment by an MQP Company of the Supplemental MQP Fee and the amount of such fee would be disclosed by NASDAQ on its Web site. Under the NYSE Arca Proposal, an issuer participating in the Fixed Incentive Program would be required to pay the Optional Incentive Fee in an amount between $10,000 and $40,000, which amount would be negotiated between the issuer and the LMM assigned to such issuer's ETP, and the final amount of such Optional Incentive Fee would not be publicly disclosed.
- Under the proposed Fixed Incentive Program, NYSE Arca, in its discretion, could allow an issuer to withdraw an ETP from the Fixed Incentive Program before the end of the pilot only if the assigned LMM is unable to meet its minimum performance standards for two of the three months of a quarter or for five months during the pilot, and no other qualified Equity Trading Permit Holder is able to take over the assignment and become the new LMM for the ETP. Under NASDAQ's proposed MQP, an MQP Company could voluntarily withdraw from the MQP on a quarterly basis after it has been in the MQP for two consecutive quarters, or on a monthly basis after it has been in the MQP for one year.
- Under NYSE Arca's proposed Fixed Incentive Program, an LMM could withdraw from all of its ETP assignments. In addition, NYSE Arca, in its discretion, could allow an LMM to withdraw from a particular ETP before the end of the pilot period if NYSE Arca determines that there are extraneous circumstances that prevent the LMM from meeting its minimum performance standards for such ETP that do not affect its other ETP assignments in the Fixed Incentive Program. Under NASDAQ's proposed MQP, an MQP Market Maker that is in the MQP for not less than one quarter could withdraw from the MQP on a quarterly basis. In such a case, the MQP Market Maker would be required to notify NASDAQ in writing not less than one month prior to withdrawing.
- During the pilot period, NASDAQ would provide the Commission with certain market quality data for the MQP Securities, as further described above, to allow the Commission to assess the impact of the MQP. Under the NYSE Arca Proposal, NYSE Arca would provide the Commission with certain market quality data for ETPs in the Fixed Incentive Program, and also for ETPs not participating in the program, to allow the Commission to compare such metrics. NYSE Arca expressly indicates that such data would be provided to the Commission on a confidential basis.

III. Summary of Comments and Responses to Comments

A. Comments to NASDAQ'S Proposal and NASDAQ Response Letter

The Commission received 18 comment letters on the NASDAQ Proposal.[101] Ten commenters generally supported the proposal,[102] seven commenters opposed the proposal,[103] and one commenter neither supported nor opposed the proposal, but requested a longer comment period to have sufficient time to consider the issues raised by the proposal.[104]

In the NASDAQ Response Letter, NASDAQ reiterated its belief that the MQP will be beneficial to issuers, investors, and other market participants, and to the economy in general by ''significantly enhancing the quality of the market and trading in listed securities.'' [105] In support of its proposal, NASDAQ referenced the commenters that submitted letters generally in favor of the proposed MQP.[106] NASDAQ also responded to

[100] *See infra* notes 203 and 247 and accompanying text.

[101] *See supra* notes 5 and 8.

[102] *See generally* Anonymous Letter, Weaver Letter, Anand Letter, Menkveld Letter, Angel Letter, NASDAQ ICI Letter, Knight Letter, ETF Consultants Letter, TechNet Letter, and MFA Letter.

[103] *See generally* Choi Letter, Csickso Letter, O'Connor Letter, Szalay Letter, Keita Letter, Connell Letter, and IR Letter.

[104] *See* NASDAQ Vanguard Letter at 1–2.

[105] *See* NASDAQ Response Letter at 1. NASDAQ also cited recent legislation proposed subsequent to the NASDAQ Notice sponsored by Congressman McHenry entitled ''Liquidity Enhancement for Small Public Companies Act'' noting current interest in Congress to provide for ''much needed support for small businesses.'' *See id.* at 2–3.

[106] *See id.* at 4–13. *See also supra* note 102.

comments opposing the proposed MQP, which responses are summarized below.

1. Generally Support MQP

The commenters supporting the NASDAQ Proposal generally express the view that the MQP would provide greater liquidity and create better quality markets for the securities participating in the MQP, including lower transaction costs, increased price discovery and lower volatility.[107] One commenter believes that the NASDAQ Proposal will benefit all market participants, including issuers, investors (institutional and retail), liquidity providers, and the overall U.S. economy.[108] Another commenter believes that the MQP will make a substantial contribution to improving the quality of ETF trading markets and facilitate trading in improved ETFs as new products are introduced.[109]

A number of commenters supportive of the MQP point to academic studies finding that paid for market making arrangements applied to common stocks generally improve market quality and benefit social welfare.[110] One commenter discusses his own study of paid for market making arrangements for common stocks and concludes that market makers entering into these types of agreements provide liquidity buffers against supply and demand shocks.[111] Another commenter cites his own study for the finding that a paid for market making arrangement applicable to common stocks on average improves the liquidity level, reduces liquidity risk, and reduces the size of pricing errors in such stocks, among other things.[112] One commenter cites a study for the proposition that maintaining a level of liquidity provision that is higher than the level that would endogenously arise can increase welfare and enhance efficiency for certain securities.[113]

A number of commenters supportive of the MQP also state that direct payments from issuers to market makers are used in a number of markets outside of the U.S., and such programs have been successful.[114] One commenter states that the combined evidence from other markets indicates that a paid market making program offers significant promise for improving the liquidity of the stocks of smaller firms.[115]

Several commenters supporting the MQP believe that the MQP may incentivize not only the MQP Market Makers, but also other market participants, to make markets in the MQP Securities, thereby creating additional liquidity in the MQP Securities.[116] One commenter cites an article finding that narrower spreads arising from designated market makers with an affirmative obligation to set spreads narrower than would exist otherwise will induce both uninformed and informed traders to trade more, which in turn leads to increased price efficiency and faster price discovery.[117] Another commenter states that a study he conducted potentially indicates that other limit order traders compete more aggressively in the presence of issuer-paid market makers, thereby narrowing spreads beyond the levels mandated by contract.[118]

One commenter believes that the MQP could create value for an issuer through liquidity insurance by, ex ante, shareholders agreeing to pay for a minimum liquidity guarantee to insure against uncertain future liquidity.[119] This commenter states that if future liquidity is less uncertain, more investors should participate in the market, and thus, the MQP could be a way to jump-start trading in a particular product at launch, and if there is intrinsic interest in the product, it should have a better chance of being successful.[120] Similarly, another commenter argues that the MQP is an attractive and low cost way to assure reasonably continuous market making, so that investors that buy ETF shares will not have to be concerned that it may not be possible for them to sell their shares at a price close to the net asset value when they decide to sell.[121]

One commenter states that the incentives that previously existed on NASDAQ for market makers and brokers to nurture smaller companies no longer exist, and that the MQP is a tool to create such incentives.[122] Similarly, one commenter states that the cost to trade many of the smaller and newer ETFs is unpredictable and that incentives to market makers to undertake such costs do not exist under current market rules.[123] This commenter believes that the MQP will provide important incentives to attract market makers to participate in the introduction and continuous trading of newer, less immediately popular, ETFs, and will encourage market makers to be continuous participants in the market by looking for links and arbitrage opportunities between and among the underlying portfolio and the exchange traded product.[124]

Three commenters believe that the MQP will benefit the operating companies underlying ETFs in the MQP, in addition to the ETFs themselves.[125] One of these commenters states that it is not the inclusion in an underlying index that matters to the operating company, but rather the trading volume increase resulting from trading products based on such index.[126] Another commenter agrees with NASDAQ's assertion that membership of an index enlarges ''visibility'' of a company, as substantial trade activity will create investor interest in holding the portfolio and therefore holding the company.[127]

One commenter supports the overall goal of the MQP—to incentivize market

[107] *See* Anonymous Letter at 1, Weaver Letter at 1–2, Anand Letter at 1–2, Knight Letter at 1–2, Angel Letter at 3, TechNet Letter at 1, and MFA Letter at 2.

[108] *See* Knight Letter at 1.

[109] *See* ETF Consultants Letter at 1.

[110] *See* Weaver Letter at 2, Anand Letter at 1, Menkveld Letter at 2, and MFA Letter at 2 citing to the following studies: Weaver, D.G., A. Anand, and C. Tanggaard ''Paying for Market Quality'' *Journal of Financial and Quantitative Analysis,* Vol. 44, 1427–1457, 2009 (''Weaver Study''); Bessembinder, H., J. Hao, and M. Lemmon (2006) ''Why designate market makers? Affirmative obligations and market quality'' *Working paper,* University of Utah (''Bessembinder Study''); Menkveld, A.J. and T. Wang (2011), ''How do designated market makers create value for small-caps?'' *Manuscript,* VU University, Amsterdam (''Menkveld Study''); Skjeltorp, Johannes A. & Bernt Arne Odegaard, ''Why do listed firms pay for market making in their own stock?'' (June 2011); and Hengelbrock, Jordis, ''Designated Sponsors and Bid-Ask Spreads on Xetra,'' University of Bonn—The Bonn Graduate School of Economics (October 2008).

[111] *See* Weaver Letter at 2 citing to the Weaver Study.

[112] *See* Menkveld Letter at 1–2 citing the Menkveld Study.

[113] *See* Anand Letter at 1 citing the Bessembinder Study.

[114] *See* Weaver Letter at 3–4, Knight Letter at 1–2, Anand Letter at 1–2, Angel Letter at 3, and MFA Letter at 2. These commenters cited the Stockholm Stock Exchange, NASDAQ OMX's European exchanges, and Euronext's European exchanges, among others, as markets where such programs have been successful. Another commenter notes that NASDAQ OMX has extensive experience operating exchanges in countries that permit issuers to compensate liquidity providers, so NASDAQ should have the relevant expertise to administer such a program in the U.S. in such a manner as to prevent harm to market participants. *See* Angel Letter at 3.

[115] *See* Anand Letter at 2.

[116] *See* Weaver Letter at 2–3, Knight Letter at 2, Anand Letter at 1–2, and ETF Consultants Letter at 2.

[117] *See* Weaver Letter at 2–3 citing to the Bessembinder Study.

[118] *See* Anand Letter at 1.

[119] *See* Menkveld Letter at 2.

[120] *Id.*

[121] *See* ETF Consultants Letter at 2–3.

[122] *See* Angel Letter at 3.

[123] *See* ETF Consultants Letter at 2.

[124] *See* ETF Consultants Letter at 2.

[125] *See* Weaver Letter at 4, Menkveld Letter at 3–4, and TechNet Letter at 1.

[126] *See* Weaver Letter at 5.

[127] *See* Menkveld Letter at 3–4. Another commenter also suggests that, looking forward, the MQP could benefit promising tech companies that today may lack liquid, quality markets. *See* TechNet Letter at 1.

makers to make high-quality, liquid markets in ETFs—and asserts that, to the extent the MQP results in narrower spreads and more liquid markets for ETFs without any associated unintended consequences for ETFs or the markets as a whole, the MQP could prove beneficial.[128] However, this commenter supports the MQP at this time only through a pilot program as contemplated by the NASDAQ Proposal and the requirement that NASDAQ provide information to the Commission during the pilot about market quality associated with the MQP, to assist in the comparison of ETFs before and after they are in the MQP.[129]

2. Generally Oppose MQP

The commenters opposing the MQP raise various objections to the proposal. Several commenters opposing the NASDAQ Proposal believe that it would result in manipulation and an unfair market place.[130] In its response letter, NASDAQ argues that the MQP will serve to open the market to more participants and ''will be a win for all: For the ETF sponsor or company that lists a liquidity-challenged product with the MQP and experiences added liquidity; for the market maker that receives a modest credit for 'stepping up to the plate' and is willing to take on added risk by enhancing liquidity pursuant to MQP standards; and for the investor that experiences liquidity on both sides of the trading continuum (bid and ask) at lower transaction cost.''[131]

Several commenters opposing the NASDAQ Proposal argue that it would undo the prohibition on issuer payments for market making contained in FINRA Rule 5250, which was put in place for important investor protection reasons.[132]

Two commenters who oppose the MQP believe that it would result in an increase in statistical arbitrage, which these commenters view as speculative short-term trading and as harmful to investors and public companies.[133] NASDAQ responds that the MQP is not designed to inherently increase statistical arbitrage and that arbitrage will exist regardless of the MQP.[134] NASDAQ also notes that arbitrage may serve to help align the pricing of ETFs and allow investors to experience tighter execution related to an ETF's asset value.[135]

One commenter opposed to the MQP argues that the NASDAQ Proposal is not consistent with the Exchange Act because the proposal: (i) Authorizes ETF sponsors to pay market-makers for making markets in a distinct and narrow set of securities, and, thus, does not promote equitable allocation of reasonable dues, fees and other charges; (ii) conjures volume and prices through deliberate, systematic interference with market mechanisms and, thus, does not meet the requirement of promoting just and equitable principles of trade; and (iii) is designed to prompt behavior that would not otherwise occur through payments and, thus, is an impediment to free and open markets.[136] In response, NASDAQ states its belief that it has articulated a sufficient statutory basis to support the proposal, and argues that the goal of the MQP—to incentivize members to make high-quality, liquid markets—supports the development of a resilient and efficient national market system.[137] NASDAQ further argues that the MQP represents an equitable allocation of fees and dues among Market Makers, because Market Makers that choose to undertake increased burdens pursuant to the MQP will be rewarded on a pro rata basis with increased credits, while those that do not undertake such burdens will receive no benefit; any portion of an MQP Fee that is not credited to eligible MQP Market Makers will be refunded to the relevant MQP Company; and all of the benefits of the MQP Fees will flow to high-performing Market Makers rather than to NASDAQ, provided that at least one Market Maker fulfills the obligations under the proposed rule.[138] Finally, NASDAQ argues that the MQP is designed to avoid unfair discrimination among Market Makers and issuers because it contains objective, measurable standards for both issuers and Market Makers that NASDAQ will apply equally to ensure that similarly situated parties are treated similarly.[139]

This commenter further argues that durable markets cannot be constructed on prices contrived through payment for order flow arrangements such as the MQP, and that incentivized trading resulting from such arrangements obfuscates true supply and demand by creating volume where no natural buyers or sellers exist.[140] This commenter believes that it should be incumbent upon ETF sponsors to create vehicles that attract interest.[141]

3. FINRA Rule 5250

As discussed above, three commenters oppose the NASDAQ Proposal because they believe it would violate the prohibition against issuer payments to market makers contained in FINRA Rule 5250.[142] On the other hand, four of the commenters that support the MQP argue that the MQP adequately addresses the concerns that FINRA Rule 5250 was designed to alleviate.[143]

One of these commenters argues that the structure of the MQP and the behavior for which an MQP Market Maker is compensated would discourage inappropriate behavior by MQP Market Makers.[144] In particular, this commenter notes that the market making incentives provided by the MQP should not materially affect the likely price of the MQP Securities, as the mid-point of the price range will be

[128] *See* NASDAQ ICI Letter at 2.

[129] *See id.* at 2–3.

[130] *See* Choi Letter at 1, O'Connor Letter at 1, Szalay Letter at 1, and Connell Letter at 1.

[131] *See* NASDAQ Response Letter at 14.

[132] *See* Csicsko Letter at 1, Keita Letter at 1, and Connell Letter at 1. FINRA Rule 5250 was implemented, in part, to address concerns about issuers paying market makers to improperly influence the price of an issuer's stock. *See* NASD Rule 2460 Approval Order, *supra* note 67, at 37107 (''Specifically, the Commission finds that the rule preserves the integrity of the marketplace by ensuring that quotations accurately reflect a broker-dealer's interest in buying or selling a security. The decision by a firm to make a market in a given security and the question of price generally are dependent on a number of factors, including, among others, supply and demand, the firm's expectations toward the market, its current inventory position, and exposure to risk and competition. This decision should not be influenced by payments to the member from issuers or promoters. Public investors expect broker-dealers' quotations to be based on the factors described above. If payments to broker-dealers by promoters and issuers were permitted, investors would not be able to ascertain which quotations in the marketplace are based on actual interest and which quotations are supported by issuers or promoters. This structure would harm investor confidence in the overall integrity of the marketplace. The Commission finds that the proposed rule supports a longstanding policy and position of the NASD and establishes a clear standard of fair practice for member firms.'') The Commission's order also discussed conflicts of interest that may exist between issuers and market makers. *See id.* at 37106 (''It has been a longstanding policy and position of the NASD that a broker-dealer is prohibited from receiving compensation or other payments from an issuer for quoting, making a market in an issuer's securities or for covering the member's out-of-pocket expenses for making a market, or for submitting an application to make a market in an issuer's securities. As stated in Notice to Members 75–16 (February 20, 1975), such payments may be viewed as a conflict of interest since they may influence the member's decision as to whether to quote or make a market in a security and, thereafter, the prices that the member would quote.'')

[133] *See* Keita Letter at 1 and IR Letter at 2–3.

[134] *See* NASDAQ Response Letter at 16–17.

[135] *See* NASDAQ Response Letter at 17.

[136] *See* IR Letter at 2.

[137] *See* NASDAQ Response Letter at 16.

[138] *Id.*

[139] *Id.*

[140] *See* IR Letter at 2.

[141] *See id.*

[142] *See supra* note 132.

[143] *See* Anonymous Letter at 1, Weaver Letter at 6, NASDAQ ICI Letter at 2, and ETF Consultants Letter at 6.

[144] *See* ETF Consultants Letter at 6.

determined by market forces and not by a market maker's activity, and MQP Market Makers have an incentive under the MQP to make spreads tight, post reasonable quotes, post them consistently, and post quotes that investors will trade against since they are compensated based on both the quality of quotes and participation in trading.[145] This same commenter also argues that since the securities eligible for the MQP are ETFs, LSs, and TIRs, where net asset value proxies are provided frequently for such products during trading hours, any attempt to artificially push prices up or down would be countered by the availability of this information.[146]

One commenter argues that placing NASDAQ between the funding delivered by the issuer to the market maker will ensure the professional integrity of the MQP and the responsibility of the market maker, and thus alleviates the concerns FINRA Rule 5250 was designed to address.[147]

Another commenter notes that there have been no reports of manipulation attempts by issuers or abuses by market makers in paid for market making programs abroad, and argues that the implementation of paying for market making to improve market quality in other countries probably improved investor confidence, as evidenced by the increase in volume and order size observed by researchers.[148] This commenter also argues that the payment levels proposed in the MQP are not of sufficient size to provide enough incentive for manipulation.[149]

One commenter recognizes that the MQP would represent a departure from the current rules precluding these types of issuer payments, which were put in place to address concerns surrounding the payment of incentives to market makers, and, therefore, supports the establishment of the MQP only through a pilot program as contemplated by the proposal.[150] This commenter also notes that NASDAQ has attempted to address concerns about investor confidence and market integrity that are associated with the MQP through, among other things, disclosure requirements and overall transparency built into the MQP.[151]

The commenter who neither supported nor opposed the proposal also reserves judgment as to whether the MQP sufficiently alleviates the concerns FINRA Rule 5250 was intended to address.[152] This commenter notes that NASDAQ has proposed a number of safeguards around the MQP in an effort to address the concerns underlying the prohibition on issuer payments to market makers, including a transparency requirement wherein NASDAQ would disclose on its Web site the identity of all ETF and market makers participating in the MQP, along with information about amounts paid to or received by these participants; objective and meaningful market quality standards that market makers must meet to receive MQP payments; and opportunity for multiple market makers to compete for payments on each participating ETF. This commenter states that these safeguards are important but believes that it is unclear whether these safeguards would be sufficient to overcome the presumption that issuer payments to market makers have the potential to distort the market and create conflicts of interests that corrupt the integrity of the marketplace.[153]

In its response letter, NASDAQ states its belief that FINRA Rule 5250 was originally adopted to prohibit market makers from getting paid by issuers for increasing volume without supporting liquidity and quality markets, such as ''pump and dump'' schemes.[154] NASDAQ does not believe that the MQP will promote such negative behavior, and emphasizes various aspects of the MQP to support this, including the fact that payments made pursuant to the MQP are administered by the Exchange; an MQP Market Maker can only receive payments under the MQP by meeting the MQP performance standards; the MQP is clear, unambiguous, and transparent; and that the products that are eligible for the MQP, ETFs, have a structure that inherently protects against the opportunity for price manipulation by a market maker because their value is based on the performance of an underlying index or basket of securities.[155]

4. Additional Concerns

One commenter notes a number of additional concerns that the MQP may raise, and suggests that the Commission solicit additional public comment relating to such concerns before approving NASDAQ's Proposal.[156] The areas of concern this commenter identifies include: (i) What effect, if any, the MQP may have on ETFs that are ineligible to participate in the MQP, or that are eligible but choose not to participate; (ii) whether competitive forces will essentially render the MQP compulsory, forcing ETFs into a ''pay-to-play'' environment where new ETFs must pay for the MQP to launch and list and existing ETFs must pay for the MQP to maintain quality markets; (iii) whether NASDAQ's proposed eligibility criteria are consistent with the stated goals of the MQP and the public interest; (iv) whether ETFs for which there is a limited demand should be allowed to be artificially propped up indefinitely by the MQP rather than allowed to fail (or trade at a wider spread); [157] and (v) what implications there are for investors who purchase an ETF when it is in the MQP but seek to sell such ETF after it is no longer participating in the MQP.[158]

In response, NASDAQ states that it does not believe its proposal will cause a diminution of market quality for ETFs that do not participate in the MQP, and anticipates that the liquidity characteristics of ETFs not participating in the MQP will largely remain unchanged (*e.g.,* they will continue to be less than adequate).[159] Furthermore, NASDAQ notes that it has ''taken great strides to make the MQP wholly voluntary,'' and it does not believe the modest market maker credits proposed pursuant to the MQP will result in a ''pay to play'' environment.[160] NASDAQ also disagrees with this commenter's concern regarding whether NASDAQ's proposed eligibility criteria are consistent with the stated goals of the MQP or the public interest. NASDAQ believes that ADV over a three-month period is the proper discontinuance metric for the MQP, as the program is designed for less liquid products, and NASDAQ notes that during the pilot period, the Exchange will evaluate the efficacy of the MQP and may make adjustments to the MQP as needed.[161] NASDAQ does not believe that it would be proper to restrict the MQP to newly

[145] *Id.* at 3.

[146] *Id.* at 6.

[147] *See* Anonymous Letter at 1.

[148] *See* Weaver Letter at 4.

[149] *Id.* at 6.

[150] *See* NASDAQ ICI Letter at 2–3.

[151] *Id.* at 3.

[152] *See* NASDAQ Vanguard Letter at 3–4.

[153] *See id.* at 3. For example, this commenter queries whether it is likely that investors would consult NASDAQ's Web site for information about which ETFs and market makers are participating in the MQP and, if not, whether investors would be able to distinguish quotations that reflect true market forces from quotations that have been influenced by issuer payments. *Id.*

[154] *See* NASDAQ Response Letter at 14–15.

[155] *See* NASDAQ Response Letter at 15.

[156] *See* NASDAQ Vanguard Letter at 4.

[157] On the other hand, another commenter states its belief that the implementation of the MQP would not do much to help a small fund with an unappealing portfolio or a history of poor performance, and that if a fund is not viable, the MQP alone would not save it. *See* ETF Consultants Letter at 5.

[158] *See id.* at 4–6.

[159] *See* NASDAQ Response Letter at 18.

[160] *See id.*

[161] *See* NASDAQ Response Letter at 19.

listed ETFs, as it believes numerous products currently exist that may benefit from liquidity enhancement.[162] NASDAQ also does not believe the public interest would be better served if there was a time limit on an MQP Security's participation in the MQP, arguing that an MQP Security should be terminated from the program only once it has achieved sustained liquidity.[163] NASDAQ further argues that continued participation in the MQP should be at the discretion of the ETF sponsor and should not be limited by the Exchange or the Commission.[164]

A number of commenters supportive of NASDAQ's Proposal identified additional areas of potential concern that the MQP may raise, but went on to dispel such concerns as unwarranted.

For example, one commenter notes the potential risk that insider information at an issuer could reach an MQP Market Maker, but concludes this risk is low because there is no need for communication between an issuer and the market maker after an MQP Security enters the MQP, and because the securities for inclusion in the MQP are less likely to be affected by such insider information risk since they are baskets of securities and security-specific information is less relevant.[165]

Another commenter asserts that an ETF participating in the MQP would generally have a substantial market quality advantage over a comparable product that is not eligible for or does not participate in the MQP; however, this commenter goes on to conclude that this should not be a concern as it is inconceivable that a new ETF would launch without the MQP from the start.[166] This commenter also asserts that the discontinuance of the MQP for an MQP Security could have unintended consequences on fair and orderly markets unless the MQP Market Maker continues to trade the shares without compensation from the MQP; however, this commenter again concludes that this concern is unwarranted as the MQP Fee may be inconsequential at the point of discontinuance if the ETF is successful in gathering assets.[167]

Addressing whether the voluntary nature of the MQP may have negative or unintended effects on the market, one commenter notes that allowing issuers to determine whether to enter into paid for market making arrangements appropriately allows each issuer to weigh the benefits and costs associated with the presence of market makers, and paid for market making contracts will only exist where benefits exceed the costs.[168]

5. MQP Standards

a. Generally Support

Three commenters support the specific provisions and structure of the MQP, stating their view that the standards set forth in proposed NASDAQ Rule 5950 are sufficiently clear and well-designed.[169] One commenter supports the proposed MQP Market Maker compensation framework for creating the right incentives, noting that because MQP Market Makers receive payments only when they maintain a quality market through quoting and when they provide actual liquidity to buyers and sellers through trading, the rule structure assures that there will be a two-sided market when an investor seeks to buy shares in an MQP Security and a similar two-sided market when an investor returns to the market to sell such shares.[170] Similarly, another commenter applauds NASDAQ for basing payments not only on quote activity, but also on actual trade activity resulting from those quotes.[171] One commenter supports limiting the scope of the MQP to ETFs, LSs and TIRs as proposed.[172]

b. MQP Supplemental Fee

One commenter voices support for the MQP Supplemental Fee provision of the MQP, noting that permitting MQP issuers to pay the additional Supplemental MQP Fee at their discretion and to determine how to allocate such fee between quotation and trading performance is appropriate, as the standards set forth in the MQP may not necessarily be right for every product.[173]

c. Trading Volume Threshold

Four commenters discussed the proposed termination of the MQP for any MQP Security that sustains ATV of 2,000,000 shares or more for three consecutive months.[174] One commenter believes that 2,000,000 ATV is an arbitrary threshold that is no better or worse than any other large number, and that the number may need to be adjusted after the MQP has been implemented.[175] Similarly, another commenter notes that the determination of the correct threshold for discontinuance of the MQP is an area that will require additional study, and it is not clear that a hard threshold will be the most efficient means of determining whether a security remains in the MQP.[176] Another commenter argues that any specific level of trading volume or assets under management or any other arbitrary rule as a basis for discontinuing the MQP is inappropriate.[177]

Finally, one commenter notes that, although NASDAQ positions the MQP as intended to help the most illiquid ETFs, the proposed 2,000,000 ATV threshold would permit over 90% of the ETFs in existence as of March 31, 2012 to enter the MQP.[178] This commenter suggests that the Commission consider whether a lower trading volume threshold would be more consistent with the stated goals of the MQP as well as the public interest, or alternatively, whether MQP eligibility should be based on a metric other than trading volume, such as actual quotation and/or transaction data, or should be restricted to newly created ETFs, or whether a security's participation in the MQP should be limited to a defined period of time, such as one or two years.[179] As discussed above, NASDAQ states in its response letter its belief that the proposed 2,000,000 ATV threshold is appropriate at this time, as the MQP is designed for less liquid products, and it believes the program should be terminated with respect to a particular product once it has achieved sustained liquidity.[180] Nasdaq also states in its response letter that it does not believe the MQP should be restricted to newly issued ETFs or that a security's participation in the MQP should be time-limited, as it believes that not only newly listed products, but also many products currently existing may benefit from the program, and that continued

[162] *See id.*

[163] *See id.*

[164] *See id.*

[165] *See* Menkveld Letter at 3.

[166] *See* ETF Consultants Letter at 7.

[167] *See id.* at 7–8.

[168] *See* Anand Letter at 1. This commenter cites the Weaver Study finding that firms with relatively illiquid stocks enter into contracts with market makers, firms with high levels of liquidity do not contract with market makers, and firms with very low levels of liquidity are also less likely to enter into contracts with market makers. *Id.*

[169] *See* Weaver Letter at 1, Knight Letter at 2, and ETF Consultants Letter at 1–2.

[170] *See* ETF Consultants Letter at 3.

[171] *See* NASDAQ Vanguard Letter at 3, n.7.

[172] *See* MFA Letter at 2. This commenter states that it would have reservations were the MQP to apply to single-name securities, as the commenter believes that payment by corporate issuers for market-making could change the market dynamics. *See id.*

[173] *See* ETF Consultants Letter at 7.

[174] *See generally* Weaver Letter, Knight Letter, NASDAQ Vanguard Letter, and ETF Consultants Letter.

[175] *See* Weaver Letter at 8.

[176] *See* Knight Letter at 2.

[177] *See* ETF Consultants Letter at 7.

[178] *See* NASDAQ Vanguard Letter at 5.

[179] *See id.*

[180] *See* NASDAQ Response Letter at 19. *See also supra* note 161 and accompanying text.

participation in the program should be at the discretion of the MQP Company and should not be time-limited.[181]

d. Suggested Additional Disclosure

One commenter suggests that participation in the MQP should be noted on the MQP Security's Web site and in regulatory disclosure documents.[182]

Another commenter suggests that a ticker symbol identifier would be useful for products in the MQP, as products in the MQP will generally have lower volatility.[183] NASDAQ believes that ''changing the ticker symbol of a product in the MQP is neither necessary nor desirable,'' noting the transparency of the MQP and the Web site disclosure of the products accepted into the MQP, as well as the market makers in such product.[184]

6. Fee Payment Clarification

One commenter believes that it is unclear in the Notice and proposed rule text whether the MQP Fees will be paid by ETF sponsors or the ETFs themselves.[185] This commenter argues that if the ETF rather than the ETF sponsor is paying the MQP Fee, this would change the entire financial dynamic of the MQP because it would require existing ETF investors to pay for enhanced liquidity.[186] In response, NASDAQ states that the ETF sponsors will be paying for the MQP.[187]

Two other commenters argue that it is irrelevant whether the ETF sponsor or the ETF itself pays the MQP Fees, because if the sponsor is paying the fee, it will factor the cost into the fee structure of the ETF, and if the ETF is paying the fee, the sponsor will likely absorb the fee either by capping the expense ratio of the ETF or paying the fee itself.[188]

7. Pilot Program

Eight commenters support implementing the MQP on a pilot basis as proposed, and believe that the pilot will provide useful information to gauge the effectiveness of the MQP.[189] Three commenters support the proposed one-year time period for the pilot.[190]

Two commenters suggest improvements to the implementation of the pilot to allow the Commission and NASDAQ to more effectively assess the impact of the MQP.[191] One of these commenters suggests that the pilot have a staggered introduction of MQP Securities with a randomized sequence, and a long enough pre-and post-event period (*e.g.,* three months) for each introduction to identify an effect.[192] In addition, this commenter suggests that NASDAQ provide the Commission with detailed reporting of all trades and quotes in all securities for a pre-event period and a post-event period (with MQP Market Maker trades and quotes flagged).[193] NASDAQ disagrees with this commenter's suggestions for the pilot program, asserting that a staggered introduction of MQP Securities and a randomized sequence would add ''un-needed complexity to the program, and is not necessary in light of the optional nature of the MQP'' and that any pre-event period would be ''antithetical to the goal of the program to enhance liquidity of products as soon as possible.'' [194] Another commenter notes that any ''before and after'' data needed can be obtained by comparing trading and asset growth in existing products which move into the MQP after it is launched, and a period after an ETF launch without participation in MQP would be an unnecessary and inappropriate handicap for new ETFs.[195] NASDAQ agrees with this commenter.[196]

Another commenter believes NASDAQ should be required to monitor market quality metrics during the pilot not only for ETFs participating in the MQP, but also for ETFs that do not participate in the MQP, to determine whether the non-participating ETFs are negatively affected.[197]

One commenter suggests that NASDAQ be required to make available the data gathered under the pilot program to ETF sponsors participating in the MQP.[198] NASDAQ states that it intends to give sponsors access to trading data associated with liquidity provision in their products such as, for example, the performance of market makers for such products.[199]

Another commenter suggests that NASDAQ disclose publicly on a monthly basis each MQP Market Maker's share of Quote Share Payments and Trade Share Payments for each MQP Security the market maker trades.[200]

8. Timing

Two commenters state that the proposal raises significant issues and suggest that the Commission provide additional time for the submission of comments,[201] and one of these commenters specifically suggests additional areas in which the Commission should seek comment.[202] These two commenters also note that the NYSE Arca Proposal raises similar issues to the MQP, and suggest that the Commission consider the two proposals together.[203]

B. Comments to NYSE Arca's Proposal

The Commission received three commenter letters on the NYSE Arca Proposal.[204] One commenter generally supports the goals of the Fixed Incentive Program, but questions whether the program will actually benefit investors.[205] Another commenter opposes the Fixed Incentive Program.[206] Both of these commenters believe that NYSE Arca's Proposal raises additional issues that were not raised in NASDAQ's proposal.[207] Another commenter supports NYSE Arca's proposal, but believes that the party that would be paying the Optional Incentive Fee (whether it be the ETP sponsor or shareholder) should be disclosed in the ETP's offering documents.[208]

1. Generally Support Fixed Incentive Program

Two commenters generally support the overall goal of the Fixed Incentive Program, and state their views that, to the extent the Fixed Incentive Program results in narrower spreads and more liquid markets for ETPs, without any associated unintended consequences for ETPs or the markets as a whole, the Fixed Incentive Program could prove

[181] *See* NASDAQ Response Letter at 19. *See also supra* notes 162–164 and accompanying text.

[182] *See* ETF Consultants Letter at 8.

[183] *See* Weaver Letter at 9.

[184] *See* NASDAQ Response Letter at 7–8.

[185] *See* NASDAQ Vanguard Letter at 6.

[186] *Id.*

[187] *See* NASDAQ Response Letter at 11 and 20.

[188] *See* Weaver Letter at 7 and ETF Consultants Letter at 3–4.

[189] *See generally* Weaver Letter, Menkveld Letter, Anand Letter, NASDAQ ICI Letter, Knight Letter, NASDAQ Vanguard Letter, ETF Consultants Letter, and MFA Letter.

[190] *See* Weaver Letter at 8, Menkveld Letter at 4, and ETF Consultants Letter at 8.

[191] *See* Menkveld Letter at 4–5 and NASDAQ Vanguard Letter at 4–5.

[192] *See* Menkveld Letter at 4.

[193] *Id.* at 4–5.

[194] *See* NASDAQ Response Letter at 9.

[195] *See* ETF Consultants Letter at 8.

[196] *See* NASDAQ Response Letter at 12.

[197] *See* NASDAQ Vanguard Letter at 4.

[198] *See* NASDAQ ICI Letter at 3.

[199] *See* NASDAQ Response Letter at 11.

[200] *See* ETF Consultants Letter at 8.

[201] *See* NASDAQ ICI Letter at 1 and NASDAQ Vanguard Letter at 1–2.

[202] *See* NASDAQ Vanguard Letter at 4–6; *see also supra* notes 156–158 and accompanying text.

[203] *See* NASDAQ ICI Letter at 1, n.3 and NASDAQ Vanguard Letter at 5–6. *See also infra* note 247.

[204] *See supra* notes 13 and 16.

[205] *See* NYSE Arca ICI Letter at 2.

[206] *See* NYSE Arca Vanguard Letter at 2.

[207] *See* NYSE Arca ICI Letter at 2 and NYSE Arca Vanguard Letter at 2.

[208] *See* USCF Letter at 3.

beneficial.[209] One commenter states that the number and quality of firms that are both able and willing to serve as an LMM has declined dramatically.[210] This commenter asserts that the current lack of LMMs willing to support new listings raises the concern that ETP issuers that also have extensive trading and money management efforts in non-ETP markets (such as in the open-end mutual fund or institutional fund management markets) may use such non-ETP trading revenue to attract market makers and LMMs to make markets in their ETP listings, to the disadvantage of ETPs without such outside trading revenue.[211] This commenter believes that the Fixed Incentive Program would help to alleviate the concerns it has about the decline in the current robustness of the LMM universe.[212] Another commenter states that, while it supports the goals of market maker incentive programs such as the Fixed Income Program, it is unclear, at this time, whether such programs will result in overall benefits to investors.[213]

2. Opposes Fixed Incentive Program

Another commenter opposes NYSE Arca's Proposal and argues that the Commission should not approve the Fixed Incentive Program until NYSE Arca articulates and provides support for the purported benefits to the markets and long-term investors that the program will provide.[214] This commenter argues that issuer payments to market makers are prohibited, and exceptions to that prohibition should be made only if the rationale is compelling and the exception is narrowly tailored to accomplish an important public policy goal, such as providing demonstrable benefits to long-term investors.[215] This commenter states that NYSE Arca has focused on the needs of market makers and has provided little evidence demonstrating how the Fixed Incentive Program will benefit investors.[216] Furthermore, this commenter argues that, even if incentivizng market makers to serve as LMMs (as opposed to benefiting investors) were a sufficient objective, NYSE Arca's Proposal is not narrowly tailored to achieve that objective, as, according to the data provided by NYSE Arca in support of its proposal, more than 90% of ETPs manage to attract and retain LMMs under the existing compensation arrangements.[217]

3. Concerns Raised by NYSE Arca Proposal

One commenter notes that NYSE's Arca's Proposal, like all market maker incentive programs, represents a departure from current rules precluding market makers from accepting payment from an issuer for acting as a market maker and raises conflict of interest concerns.[218] In addition, this commenter asserts that some of the elements of NYSE Arca's Proposal could raise potential conflicts of interest between an LMM and an ETP issuer; specifically, certain elements of the NYSE Arca Proposal could provide incentives for LMMs to pressure ETP issuers to place every NYSE Arca-listed ETP in the Fixed Program or face the threat of the withdrawal of the LMM from making a market in that issuer's ETPs.[219]

Another commenter states that NYSE Arca's Proposal raises many of the same concerns as NASDAQ's Proposal, including: (i) Whether issuer payments to market makers could have the potential to distort market forces; (ii) failure to place a time limit on an ETP's participation in the Fixed Incentive Program could raise concerns; (iii) the Fixed Incentive Program could lead to diminished market making activity in ETPs that are ineligible to, or choose not to, participate in the program; and (iv) the NYSE Arca Proposal could create a pay-to-play environment, effectively forcing issuers to pay a fee to maintain quality markets for their eligible ETPs.[220]

In addition, this commenter asserts that NYSE Arca's Proposal raises additional concerns beyond NASDAQ's Proposal because of NYSE Arca's rationale for the Fixed Incentive Program and the structure of the Fixed Incentive Program.[221] For example, this commenter states that NYSE Arca's justification for the Fixed Incentive Program focuses on the needs of LMMs and provides little evidence demonstrating how the Fixed Incentive Program would benefit investors.[222] In addition, to prevent ETP issuers from enrolling in the Fixed Incentive Program an ETP that already has ample trading volume and good market quality, the commenter believes that NYSE Arca should include objective eligibility criteria tied to trading volume and/or market quality, as such criteria would ensure that issuer payments to LMMs would be permitted only in situations where existing compensation arrangements are demonstrably insufficient to incentivize market makers to serve as LMMs.[223] The commenter also asserts that, to benefit investors, the Fixed Incentive Program should impose materially higher minimum performance standards on LMMs.[224] Finally, the commenter asserts that, in contrast to the NASDAQ Proposal, investors purchasing and selling shares of ETPs participating in the Fixed Incentive Program will not benefit unless (a) the ETP issuer, independent of the Fixed Incentive Program, requires the LMM to meet enhanced performance standards, or (b) the LMM maintains a higher quality market than would exist in the absence of the Fixed Incentive Program; the commenter argues that NYSE Arca has not demonstrated that either of the above outcomes will consistently occur.[225]

a. Lack of Higher Performance Standards

Two commenters voice concerns that LMMs in the Fixed Incentive Program do not have higher performance standards than LMMs not participating in the Fixed Incentive Program, and suggest that NYSE Arca impose higher performance standards on LMMs participating in the Fixed Incentive Program.[226] One commenter argues that requiring heightened performance standards to receive the Optional Incentive Fee would address conflict of interest concerns, may provide a greater incentive for LMMs to make better markets in ETPs, and would make the overall standards of the Fixed Incentive Program more transparent to issuers and investors.[227]

b. Lack of Competition Among Market Makers

Two commenters believe it is significant that, under the NYSE Arca Proposal, only one LMM would be assigned to an ETP participating in the Fixed Incentive Program, while under the NASDAQ Proposal, multiple market makers would compete to receive fees

[209] *See* NYSE Arca ICI Letter at 2 and USCF Letter at 1–2.

[210] *See* USCF Letter at 2.

[211] *See id.*

[212] *See id.*

[213] *See* NYSE Arca ICI Letter at 2, n.6.

[214] *See* NYSE Arca Vanguard Letter at 2.

[215] *See id.*

[216] *See id.*

[217] *See id.*

[218] *See* NYSE Arca ICI Letter at 2.

[219] *See id.* at 3–4. The commenter notes, however, that limiting the number of ETPs from a single issuer in the Fixed Incentive Program would prevent incentives for LMMs to pressure ETP issuers to place each and every ETP listed on NYSE Arca into the Fixed Incentive Program. *See id.* at 4.

[220] *See* NYSE Arca Vanguard Letter at 2, n.7.

[221] *See id.* at 2.

[222] *See id.*

[223] *See id.* at 3.

[224] *See id.*

[225] *See id.*

[226] *See* NYSE Arca ICI Letter at 3 and NYSE Arca Vanguard Letter at 3.

[227] *See* NYSE Arca ICI Letter at 3.

from the MQP.[228] One commenter argues that the Fixed Incentive Program is not competitive because all the money contributed by a participating ETP issuer goes to its designated LMM so long as that LMM meets the existing minimum standards.[229]

c. Additional Eligibility Criteria

Two commenters are concerned that, unlike NASDAQ's Proposal, there are no liquidity or trading volume requirements on ETPs that may participate in the Fixed Incentive Program.[230] One commenter notes that, as proposed, nothing prevents an ETP issuer from enrolling in the Fixed Incentive Program an ETP that already has ample trading volume and therefore robust market maker activity and good market quality.[231] To address these concerns, these two commenters recommend that NYSE Arca limit the type of ETPs permitted into the Fixed Incentive Program based on trading volume.[232] One commenter argues that if an ETP without an LMM has sufficient market maker activity to generate a consistent, fair, and orderly market, then there is no compelling rationale for the issuer to pay for an LMM, and such payments should not be permitted.[233]

4. Fixed Incentive Program Standards

One commenter voices support for certain provisions of NYSE Arca's Proposal, such as the ability for issuers to choose the LMMs for their ETPs in the Fixed Incentive Program and the ability of issuers to negotiate the Optional Incentive Fee with their assigned LMM.[234] This commenter asserts that, given that the NYSE Arca market structure does not allow for competing market makers, the choice of a specific LMM for an issuer may be more significant than that on other markets where multiple market makers exist.[235]

Two commenters support the proposed limit on the number of ETPs that an issuer may have in the Fixed Incentive Program.[236] One of these commenters believes that limiting the number of ETPs from a single issuer in the Fixed Incentive Program will prevent any incentive for LMMs to pressure ETP issuers to place every ETP listed on NYSE Arca in the Fixed Incentive Program.[237]

5. Fee Payment Clarification

Three commenters raised the issue of which party or entity would be paying the Optional Incentive Fee.[238] Two commenters believe that it is unclear from NYSE Arca's Proposal whether the entity paying the Optional Incentive Fee is the ETP sponsor or the fund itself and request that NYSE Arca clarify this element of the proposal.[239] One of these commenters asserts that if the fund itself pays the fee, the amount of the fee will be incorporated in the fund's expense ratio and will be borne by the fund's shareholders, raising their cost of ownership, and it is unlikely that the amount the Fixed Incentive Program might save investors in the form of narrower spreads would offset the increase in expense ratio.[240] This commenter further argues that the bulk of any savings that would result from the narrowing of spreads would accrue to frequent traders, while long-term buy-and-hold investors would see little or no savings in spread costs to offset the increased expense ratio.[241] Another commenter does not believe that the NYSE Arca Proposal needs to specify who would be paying the Optional Incentive Fee, but believes the Program should be amended to require clear disclosure in the ETP's offering documents of who would be responsible for the fee payment, whether it be the ETP sponsor or the ETP shareholders.[242]

6. Pilot Program

Two commenters support the pilot program aspect of the Fixed Incentive Program.[243] One commenter believes it is important that NYSE Arca and the Commission have an opportunity to evaluate the impact of the program on the quality of markets in ETPs prior to considering its permanent approval, both with respect to ETPs participating in the program and those ETPs that choose not to participate.[244] In addition, this commenter believes that statistics on the performance of LMMs during the pilot should be publicly disclosed, as such information could provide meaningful information to investors and would facilitate assessing how much liquidity is being provided by LMMs in the Fixed Incentive Program.[245] Another commenter suggests that the Commission consider under what circumstances the Fixed Incentive Program should move forward from being a pilot program to a permanent one, recommending that there be a review process to ensure that the pilot program did not produce unintended consequences.[246]

7. Consideration of the SRO Proposals Together

Two commenters recommend that the Commission consider the SRO Proposals together as they raise many of the same issues, and generally raise the question of whether to permit ETP issuers to pay for market making services.[247]

IV. Proceedings To Determine Whether To Approve or Disapprove SR–NASDAQ–2012–043 and SR–NYSEArca–2012–37 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act to determine whether the SRO Proposals should be approved or disapproved. Institution of such proceedings is appropriate at this time in view of the significant legal and policy issues raised by the SRO Proposals that are discussed below. The institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described in greater detail below, the Commission seeks and encourages interested persons to provide additional comment on the SRO Proposals.

Pursuant to Section 19(b)(2)(B), the Commission is providing notice of the grounds for disapproval under consideration. In particular, Section 6(b)(4) of the Act[248] requires that the rules of a national securities exchange provide for the equitable allocation of reasonable dues, fees and other charges among its members and issuers and

[228] *See* NYSE Arca ICI Letter at 2, n.5 and NYSE Arca Vanguard Letter at 3.

[229] *See* NYSE Arca Vanguard Letter at 3.

[230] *See* NYSE Arca ICI Letter at 3 and NYSE Arca Vanguard Letter at 3.

[231] *See* NYSE Arca Vanguard Letter at 3. On the other hand, one commenter believes that the design of the NYSE Arca Proposal tends to provide a disincentive for an LMM to take part in the program when dealing with ETPs that are already actively trading and eliminates the concern that LMMs will be paid more for doing little to nothing extra. *See* USCF Letter at 3.

[232] *See* NYSE Arca ICI Letter at 3–4 and NYSE Arca Vanguard Letter at 3. One of these commenters states that other market quality criteria would also be acceptable. *See* NYSE Arca Vanguard Letter at 3, n.9.

[233] *See* NYSE Arca Vanguard Letter at 3, n.9.

[234] *See* NYSE Arca ICI Letter at 2.

[235] *See id.* at 3.

[236] *See* NYSE Arca ICI Letter at 2 and USCF Letter at 3.

[237] *See* NYSE Arca ICI Letter at 4.

[238] *See* NYSE Arca ICI Letter at 3, n.8, NYSE Arca Vanguard Letter at 3–4, and USCF Letter at 3.

[239] *See* NYSE Arca ICI Letter at 3, n.8 and NYSE Arca Vanguard Letter at 3–4.

[240] *See* NYSE Arca Vanguard Letter at 4.

[241] *See id.*

[242] *See* USCF Letter at 3.

[243] *See* NYSE Arca ICI Letter at 4 and USCF Letter at 3.

[244] *See* NYSE Arca ICI Letter at 4.

[245] *See id.*

[246] *See* USCF Letter at 3.

[247] *See* NYSE Arca Vanguard Letter at 2 and NYSE Arca ICI Letter at 2, n.6.

[248] 15 U.S.C. 78f(b)(4).

other persons using its facilities, and Section 6(b)(5) of the Act [249] requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

Two commenters stressed the need to consider the SRO Proposals together because they raise similar issues relating to payment for market making programs,[250] and urged the Commission to provide additional time for the public to consider the SRO Proposals and to submit comments.[251] In addition, several commenters expressed concerns with payment for market making programs generally and with certain details of the SRO Proposals.[252] Moreover, certain commenters expressed concerns with the structure of the pilot programs for the SRO Proposals, and whether the information to be provided by the Exchanges to the Commission would allow the Commission to meaningfully assess the impact of the Programs.[253] One commenter noted its belief that the NASDAQ Proposal was not consistent with the Exchange Act.[254] On the other hand, several commenters expressed support for the SRO Proposals designed to incentivize market makers to make quality and/or consistent, fair, and orderly markets in certain ETPs.[255]

The SRO Proposals would allow issuers of certain ETPs to pay an additional fee to a national securities exchange, which fee (or a large portion thereof) would in turn be paid to one or more market makers for making markets in such security. As proposed, any payments made by issuers pursuant to the SRO Proposals would appear to violate FINRA Rule 5250.[256] In addition, absent exemptive relief, any payments made by issuers pursuant to the SRO Proposals would violate Rule 102 under Regulation M.[257] Furthermore, the SRO Proposals raise issues under Section 11(d)(1) of the Act [258] and Rule 12b–1 [259] under the Investment Company Act of 1940 (''1940 Act'').

Regulation M. Because pricing integrity is essential during the offering process, the Commission proscribes certain activity in connection with distributions.[260] Specifically, Rule 102 of Regulation M prohibits, in connection with a distribution of securities, issuers, selling security holders, and their affiliated purchasers from directly or indirectly bidding for, purchasing, or attempting to induce others to bid for or purchase covered securities—including the security that is the subject of the distribution—during the applicable restricted period.[261] The purpose of this prohibition is to ''prevent those persons participating in a distribution of securities * * * from artificially conditioning the market for the securities in order to facilitate the distribution'' as well as ''to protect the integrity of the securities trading market as an independent pricing mechanism.'' [262] As the Commission has stated, attempts to induce bids or purchases of covered securities outside of the distribution raise substantial concerns about whether they would fundamentally interfere with the independence of the market dynamics that are essential to the ability of investors to evaluate the terms on which securities are offered.[263]

The Commission believes that issuer payments made under the SRO Proposals would constitute an indirect attempt by the issuer [264] of a covered security to induce a purchase or bid in a covered security during a restricted period in violation of Rule 102.[265] Under the NASDAQ Proposal, the issuer payments would ''be used for the purpose of incentivizing one or more Market Makers in the MQP Security,'' [266] which could induce bids or purchases for the issuer's security during a restricted period. Under the NYSE Arca Proposal, the purpose of the Program is ''to create a Fixed Incentive Program for issuers of certain ETPs listed'' on NYSE Arca,[267] which likewise could induce bids or purchases for the issuer's security during a restricted period.

As a result, participation in the Programs by an MQP Company, in the case of the NASDAQ Proposal, or issuer that is an ETP, in the case of the NYSE Arca Proposal, would violate Rule 102, absent exemptive relief.[268] While the Commission or staff has granted relief from Rule 102 to a number of ETPs,[269]

[249] 15 U.S.C. 78f(b)(5).

[250] *See supra* notes 203 and 247 and accompanying text.

[251] *See supra* notes 201–202 and accompanying text.

[252] *See supra* notes 130–141, 156–168, and 214–233 and accompanying text.

[253] *See supra* notes 191–197 and accompanying text.

[254] *See supra* note 136.

[255] *See supra* notes 107–129, 169–172, 209–213, and 235–237 and accompanying text.

[256] *See* NASDAQ Notice, *supra* note 4, at 22043 (stating NASDAQ's belief that FINRA intends to file an immediately effective rule change exempting exchange programs approved by the Commission from FINRA Rule 5250) and NYSE Arca Notice, *supra* note 12, at 29420–21 (stating NYSE Arca's belief that FINRA would be filing an immediately effective rule change indicating that participation by LMMs and issuers in the Fixed Incentive Program would not be prohibited by FINRA Rule 5250).

FINRA Rule 5250 states, in relevant part, that ''[n]o member or person associated with a member shall accept any payment or other consideration, directly or indirectly, from an issuer of a security, or any affiliate or promoter thereof, for publishing a quotation, acting as a market maker in a security, or submitting an application in connection therewith.'' FINRA Rule 5250 was implemented, in part, to address concerns about issuers paying market makers to improperly influence the price of an issuer's stock. *See* NASD Rule 2460 Approval Order, *supra* note 67, at 37107 (noting that the rule preserves the integrity of the marketplace by ensuring that quotations accurately reflect a broker-dealer's interest in buying or selling a security and that the decision by a firm to make a market in a given security and the question of price should not be influenced by payments to the member from issuers or promoters; if payments to broker-dealers by promoters and issuers were permitted, investors would not be able to ascertain which quotations in the marketplace are based on actual interest and which quotations are supported by issuers or promoters).

[257] 17 CFR 242.102.

[258] 15 U.S.C. 78k(d)(1).

[259] 17 CFT 270.12b–1.

[260] *See* Securities Exchange Act Release No. 50831 (Dec. 9, 2004), 69 FR 75774 (Dec. 17, 2004).

[261] 17 CFR 242.102.

[262] *See* Securities Exchange Act Release No. 33924 (Apr. 19, 1994), 59 FR 21681 (Apr. 26, 1994).

[263] *See Commission Guidance Regarding Prohibited Conduct in Connection with IPO Allocations,* Securities Exchange Act Release No. 51500 (April 7, 2005), 70 FR 19672, 19673 (April 13, 2005).

[264] Payments to the participating market makers under the NYSE Arca Proposal would be made by the issuer (via NYSE Arca), but under the NASDAQ Proposal, they would be made by the MQP Company (via NASDAQ). ''MQP Company'' is defined as the ''fund sponsor or other entity that lists one or more MQP Securities on NASDAQ.'' *See* proposed NASDAQ Rule 5950(e)(7). For exchange traded notes and trust issued receipts, the sponsor and issuer are the same entity. For exchange traded funds, the payments are for the benefit of the issuer (the fund). The Commission would view all of these payments as constituting an indirect attempt by the issuer to induce a purchase or bid.

[265] As the securities participating in the SRO Proposals are ETPs that are in continuous distribution, these securities are always in a restricted period under Rule 102.

[266] Preamble to proposed NASDAQ Rule 5950. *See also* NASDAQ Notice, *supra* note 4, at 22043.

[267] *See* NYSE Arca Notice, *supra* note 12, at 29419.

[268] The exception in Rule 102 for the redeemable securities of open-end investment companies is not available for ETFs such as those participating in the Programs. *See* 17 CFR 242.102(d)(4). This is because while ETFs operate under exemptions from the definitions of ''open-end company'' under Section 5(a)(1) of the 1940 Act and ''redeemable security'' under Section 2(a)(32) of the 1940 Act, neither they nor the securities that they issue meet those definitions.

[269] *See, e.g.,* Letter from James A. Brigagliano, Acting Associate Director, Division of Market Regulation, to Stuart M. Strauss, Esq., Clifford Chance US LLP (Oct. 24, 2006) (regarding class relief for exchange traded index funds).

this relief is designed to permit the ordinary operations (*i.e.,* redemptions of ETP securities) of the ETP. Participation in the SRO Programs is not necessary for the operation of the ETP in the same way that redemptions are necessary. Moreover, commenters raised concerns that the proposed issuers' payments to market makers have the potential to distort market forces, impact pricing integrity, and prevent investors from distinguishing quotations that reflect true market forces from quotations that have been influenced by issuer payments, and that the proposed safeguards of the Programs may not be sufficient to overcome such distortions.[270] Regulation M, among other things, is intended to assure that distributions of securities are free of the market effects of bids, purchases, and inducements to purchase by those who have an interest in the success of a distribution. Thus, the Commission would need to consider whether it would be appropriate to grant exemptive relief in these circumstances, including whether there would be any alternative means to address these concerns, which could be established through conditions to any exemptive relief.

Rule 12b–1. The Commission notes that MQP Securities (in the case of the NASDAQ Proposal) and ETPs (in the case of the NYSE Arca Proposal) that operate as ETFs registered under the 1940 Act are prohibited from paying for distribution of their shares, unless such payments are made pursuant to a plan that meets the requirements of Rule 12b–1 under the 1940 Act. An ETF's board of directors should therefore initially (and periodically thereafter) evaluate the purpose and effect of MQP Fees/Optional Incentive Fees (as applicable) proposed to be made by an ETF to determine that such payments would be in compliance with that provision. In addition, the ETF's board should consider initially (and periodically thereafter) whether such fees to be paid by an ETF's investment adviser or other affiliate would be an indirect use of fund assets for distribution in assessing the appropriateness of advisory or other fees paid by the ETF to such persons.[271]

In the NASDAQ Response Letter, NASDAQ noted its belief that Rule 12b–1 is not implicated by payments made pursuant to the MQP because the MQP payments are being made by ETF sponsors, rather than the ETFs themselves.[272] The Commission notes that the prohibition in Rule 12b–1 applies to both direct and indirect payments made by ETFs registered under the 1940 Act.

Section 11(d)(1). Section 11(d)(1) of the Exchange Act[273] generally prohibits a broker-dealer from extending or maintaining credit, or arranging for the extension or maintenance of credit, on shares of new issue securities, if the broker-dealer participated in the distribution of the new issue securities within the preceding 30 days. The Commission's view is that shares of open-end investment companies and unit investment trusts registered under the 1940 Act, such as ETF shares, are distributed in a continuous manner, and broker-dealers that sell such securities are therefore participating in the ''distribution'' of a new issue for purposes of Section 11(d)(1).[274]

The Commission, acting under delegated authority, granted an exemption from Section 11(d)(1) and Rule 11d1–2 thereunder for broker-dealers that have entered into an agreement with an ETF's distributor to place orders with the distributor to purchase or redeem the ETF's shares (''Broker-Dealer APs).[275] The SIA Exemption allows a Broker-Dealer AP to extend or maintain credit, or arrange for the extension or maintenance of credit, to or for customers on the shares of qualifying ETFs subject to the condition that neither the Broker-Dealer AP, nor any natural person associated with the Broker-Dealer AP, directly or indirectly (including through any affiliate of such Broker-Dealer AP), receives from the fund complex any payment, compensation or other economic incentive to promote or sell the shares of the ETF to persons outside the fund complex, other than non-cash compensation permitted under NASD Rule 2830(l)(5)(A), (B), or (C). This condition is intended to eliminate special incentives that Broker-Dealer APs and their associated persons might otherwise have to ''push'' ETF shares.

The SRO Proposals would permit certain issuers, including ETFs, to voluntarily pay increased listing fees to the Exchanges. In turn, the Exchanges would use the fees to pay market makers incentives to improve the liquidity of participating issuers' securities, and thus enhance the market quality for the participating issuers. Incentives would be accrued for, among other things, executing purchases and sales on the Exchanges. Receipt of the incentive payments by certain broker-dealers would implicate the condition of the SIA Exemption from the new issue lending restriction in Section 11(d)(1) of the Exchange Act discussed above.

The Commission's view is that the incentives market makers would receive under the SRO Proposals are indirect payments from the fund complex to the market maker and that those payments are compensation to promote or sell the shares of the ETF. If the SRO Proposals were approved, a market maker that also is a Broker-Dealer AP for an ETF (or an associated person or an affiliate of a Broker-Dealer AP) that receives the incentives would not be able to rely on the SIA Exemption from Section 11(d)(1). This does not mean that Broker-Dealer APs could not participate in the SRO Proposals, if they were approved; it merely means they could not rely on the SIA Exemption while doing so. Thus, Broker-Dealer APs that participate in the SRO Proposals would need to comply with Section 11(d)(1) unless there is another applicable exemption.

In light of the comments received and the importance of the policy issues raised by the SRO Proposals, the Commission is seeking further comment on various aspects of the Programs to help the Commission evaluate whether the SRO Proposals are consistent with the requirements of Sections 6(b)(4) and 6(b)(5) of the Act, including whether the proposed Programs provide for the equitable allocation of reasonable dues, fees and other charges among members and issuers, and whether the Programs are designed to prevent fraudulent and manipulative acts and practices, would protect investors and the public interest, and not be designed to permit unfair discrimination between issuers, brokers or dealers.

Based on comments received on the SRO Proposals, and in light of the fact that the proposed Programs raise similar issues, the Commission is issuing this

[270] *See* IR Letter at 2 (''Incentivized trading obfuscates true supply and demand by creating volume where no natural buyers or sellers exist'') and NASDAQ Vanguard Letter at 3 (noting that ''it is not clear whether [the proposed] safeguards will be sufficient to overcome the presumption'' that issuer payments to market makers have the potential to distort the market and create conflicts of interest that corrupt the integrity of the marketplace). *See also* Choi Letter at 1 (stating that the MQP program ''will make the markets even more distorted and tilted to those who create an unfair marketplace'').

[271] *See Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies,* Investment Company Act Release No. 16431 (June 13, 1988) at n.123 and accompanying text.

[272] *See* NASDAQ Response Letter at 20.

[273] 15 U.S.C. 78k(d)(1).

[274] *See* Exchange Act Release Nos. 6726 (Feb. 8, 1962), 27 FR 1415 (Feb. 15, 1962) and 21577 (Dec. 18, 1984), 49 FR 50174 (Dec. 27, 1984).

[275] *See* Letter from Catherine McGuire, Chief Counsel, Division of Trading and Markets, Securities and Exchange Commission to Securities Industry Association (November 21, 2005) (''SIA Exemption'').

joint order to institute proceedings on both of the SRO Proposals. The Commission believes that instituting proceedings on both filings jointly through this order will facilitate the Commission's ability to solicit comment on the issues that are common to both SRO Proposals. Nevertheless, the Commission will assess each SRO Proposal separately for consistency with the requirements of the Exchange Act and the rules and regulations thereunder.

V. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues identified above, as well as any others they may have identified with the SRO Proposals. In particular, the Commission invites the written views of interested persons concerning whether the SRO Proposals are consistent with Sections 6(b)(4), 6(b)(5), or any other provision of the Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval which would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b–4, any request for an opportunity to make an oral presentation.[276]

Interested persons are invited to submit written data, views and arguments regarding whether the SRO Proposals should be approved or disapproved by August 16, 2012. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by August 31, 2012.

The Commission is asking that commenters address the merit of the statements of each Exchange in support of its respective proposed Program and the statements of commenters in response to the SRO Proposals, in addition to any other comments they may wish to submit about the SRO Proposals. Specifically, the Commission requests comment on the following aspects of the SRO Proposals:

1. FINRA Rule 5250 (formerly NASD Rule 2460) is designed to preserve ''the integrity of the marketplace by ensuring that quotations accurately reflect a broker-dealer's interest in buying or selling a security.'' [277] Specifically, in the NASD Rule 2460 Approval Order, the Commission found that the ''decision by a firm to make a market in a given security and the question of price generally are dependent on a number of factors, including, among others, supply and demand, the firm's expectations toward the market, its current inventory position, and exposure to risk and competition. This decision should not be influenced by payments to the member from issuers or promoters. Public investors expect broker-dealers' quotations to be based on the factors described above. If payments to broker-dealers by promoters and issuers were permitted, investors would not be able to ascertain which quotations in the marketplace are based on actual interest and which quotations are supported by issuers or promoters. This structure would harm investor confidence in the overall integrity of the marketplace.'' [278] The Commission also added that ''such payments may be viewed as a conflict of interest since they may influence the member's decision as to whether to quote or make a market in a security and, thereafter, the prices that the member would quote.'' [279]

Several commenters have raised concerns that issuer payments such as those proposed in the Programs could have the potential to distort the market and create conflicts of interest that could corrupt the integrity of the marketplace in violation of FINRA Rule 5250 and are not consistent with the Exchange Act.[280] Other commenters, and NASDAQ, believe that the NASDAQ Proposal addresses the concerns that FINRA Rule 5250 was designed to address.[281]

Given the rationale behind FINRA Rule 5250, what are commenters' views on whether each Program addresses (or does not address) the concerns that FINRA Rule 5250 was designed to mitigate, and why or why not? If commenters are of the view that a Program does not address the concerns that FINRA Rule 5250 was designed to mitigate, what specific safeguards, if any, could be imposed to address these concerns? Are there aspects of the Programs or features of the ETPs that would be included in the Programs that would support their exclusion from the general coverage of the Rule? If so, what are they, and why?

2. The studies cited by NASDAQ in the NASDAQ Notice and by commenters supportive of the NASDAQ Proposal examined programs applicable to equity securities of operating companies and not to other classes of securities, such as ETPs. Are there any studies that have observed paid for market making programs specifically relating to ETPs? Are there unique features of ETPs that would make market maker programs in ETPs similar to the Programs fundamentally different than market maker programs in other securities such that results of studies focused on other securities cannot be applied to similar programs for ETPs?

3. The studies cited by NASDAQ in the NASDAQ Notice and by commenters supportive of the NASDAQ Proposal looked at the market quality characteristics of equity securities of operating companies under certain market making programs, but did not provide a comparison to the market quality of those same securities before participating in such programs. Are there any studies that have compared the market qualities of securities before and during their participation in such a program? How important is this distinction? Are there any studies that have compared the market qualities of securities that did not participate in such a program to the market qualities of similar securities that participated in the same program? Are there any studies that have compared the market qualities of securities during and after their participation in such a program?

4. NASDAQ believes that the MQP will be beneficial to the financial markets, to market participants, and to the economy, in general. Specifically, NASDAQ believes that the MQP will, among other things, lower transaction costs and enhance liquidity in both ETPs and their components, making those securities more attractive to a broader range of investors, and in so doing, the MQP will help companies access capital to invest and grow. Do commenters agree with NASDAQ's argument that the MQP will enhance liquidity in both the ETP shares and the component companies comprising the underlying index or portfolio? If so, why? If not, why not? Do commenters agree with NASDAQ's assertion that the MQP will ultimately help ETP component companies to gain enhanced access to capital? If so, why? If not, why not? Please answer with specificity.

5. NASDAQ states that one of the goals of the MQP is to enhance liquidity

[276] Section 19(b)(2) of the Act, as amended by the Securities Act Amendments of 1975, Pub. L. 94–29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding—either oral or notice and opportunity for written comments—is appropriate for consideration of a particular proposal by a self-regulatory organization. *See* Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

[277] *See* NASD Rule 2460 Approval Order, *supra* note 67, at 37107.

[278] *See id.*

[279] *See id.* at 37106.

[280] *See supra* note 132 and 136 and accompanying text.

[281] *See supra* notes 143–155 and accompanying text.

in both ETFs and their components.[282] NASDAQ further states that there is a ''vital need for the MQP in the U.S. market for products facing liquidity challenges.'' [283] Are there specific examples of ETPs that would be, or whose underlying components would be, considered less liquid (and perhaps examples of ETPs that have failed in the past) that commenters consider would benefit from inclusion in the MQP?

6. NASDAQ states that the MQP is intended to help ''less actively traded'' and ''less well known'' ETFs. As such, NASDAQ proposes to terminate the MQP for an MQP Security that sustains an average ATV of 2,000,000 shares or more for 3 consecutive months. One commenter believes that 2,000,000 ATV is an arbitrary threshold that is no better or worse than any other large number, and that the number may need to be adjusted after the MQP has been implemented.[284] Similarly, another commenter asserts that the determination of the correct threshold for discontinuance of the MQP is an area that will require additional study, and it is not clear that a hard threshold will be the most efficient means of determining whether a security remains in the MQP.[285] Another commenter argues that any specific level of trading volume or assets under management or any other arbitrary rule as a basis for discontinuing the MQP is inappropriate.[286] Finally, one commenter notes that, although NASDAQ states that the MQP is intended to help the most illiquid ETFs, the proposed 2,000,000 ATV threshold would permit over 90% of the ETFs in existence as of March 31, 2012 to enter the MQP.[287] This commenter suggests that the Commission consider whether a lower trading volume threshold would be more consistent with the stated goals of the MQP as well as the public interest, or alternatively, whether MQP eligibility should be based on a metric other than trading volume, such as actual quotation and/or transaction data, or should be restricted to newly created ETFs, or whether a security's participation in the MQP should be limited to a defined period of time, such as one or two years.[288]

With respect to the NASDAQ Proposal, do commenters believe that a lower or higher trading volume threshold would be more consistent with the stated goals of the MQP as well as the public interest? Please explain. Do commenters believe that MQP applicability should be based on a metric other than trading volume, such as actual quotation and/or transaction data or another metric? Why or why not? If so, what metric(s) would commenters suggest and why? In the alternative, should ETPs be ineligible for the MQP only when the trading volume (or another measure of trading) is consistently over some reasonable level for a longer period of time (*e.g.,* 3–6 months) rather than when the ETP crosses the 2,000,000 ATV threshold for 3 consecutive months, as proposed? Why or why not? Should the MQP be restricted to newly listed ETPs? Under a Program that would terminate using a specified threshold for a particular ETP, would ETPs just above the threshold (and thus are ineligible or no longer able to participate in the Program) suffer as a result?

7. Two commenters state that, unlike NASDAQ's Proposal, there are no liquidity or trading volume requirements on ETPs that may participate in the Fixed Incentive Program.[289] One commenter notes that, as proposed, nothing prevents an ETP issuer from enrolling in the Fixed Incentive Program an ETP that already has ample trading volume and therefore robust market maker activity and good market quality.[290] To address these concerns, both commenters recommend that NYSE Arca limit the type of ETPs permitted into the Fixed Incentive Program based on trading volume.[291] One commenter argues that if an ETP without an LMM has sufficient market maker activity to generate a consistent, fair, and orderly market, then there is no compelling rationale for the issuer to pay for an LMM, and such payments should not be permitted.[292] Do commenters agree or disagree with these comments? Why or why not? Specifically, should NYSE Arca adopt liquidity or other market quality requirements for ETPs that may participate in the Fixed Incentive Program? Would this help to alleviate the concerns voiced by commenters over the NYSE Arca Proposal? Why or why not?

8. One commenter expressed the view that the Programs represent a subsidization of ETPs that, on their own, are unable to generate much trading volume.[293] Do commenters agree with this view? Why or why not? If commenters agree, what are their views on whether such ETPs should be included within the Program or be ''allowed to fail'' (or simply to trade at a wider spread) rather than artificially propped up by the Programs, as one commenter suggests? [294] Furthermore, should such ETPs be allowed to continue in the Programs indefinitely? Why or why not? Would the public interest and the protection of investors be better served if there was a time limit on participation in the Programs? Why or why not?

9. Under either of the SRO Proposals, issuers would have the discretion to exit the respective Program with respect to a particular ETP (subject to the requirements outlined in the respective SRO Proposals). Please provide comment on how, if at all, the liquidity or other market quality characteristics of an ETP participating in a Program may or may not be affected once the ETP is no longer in such Program. For example, if the issuer of the ETP ceases making payments under a Program, could removal of that ETP from a Program lead to unexpected illiquidity and/or trading disruptions for the ETP? Why or why not? If an ETP is removed from a Program, could such removal impact the spreads in the ETP? If so, why? If not, why not? If commenters believe that there may be a potential impact on market quality characteristics, do commenters believe that investors should be provided disclosure of potential impacts? If so, what type of disclosure would be effective, and why?

10. If commenters believe that removal of an ETP from a Program would impact market quality characteristics of the ETP, what are the implications, if any, for investors? For example, how might removal impact an investor's ability to buy or sell shares of the ETP during or after removal from the Program? If commenters believe that removal of an ETP from a Program could potentially negatively impact liquidity, are there other potential solutions to address this concern? For example, should the ETP sponsor allow all investors (including retail investors) to redeem their shares of the fund if the ETP exits the program?

11. Under either of the SRO Proposals, issuers and market makers would have discretion to choose to enter into the respective Program. One commenter questions whether

[282] *See* NASDAQ Response Letter at 2.

[283] *See* NASDAQ Response Letter at 1.

[284] *See* Weaver Letter at 8.

[285] *See* Knight Letter at 2.

[286] *See* ETF Consultants Letter at 7.

[287] *See* NASDAQ Vanguard Letter at 5.

[288] *See id.*

[289] *See* NYSE Arca ICI Letter at 3 and NYSE Arca Vanguard Letter at 3.

[290] *See* NYSE Arca Vanguard Letter at 3.

[291] *See* NYSE Arca ICI Letter at 3 and NYSE Arca Vanguard Letter at 3. One of these commenters states that other market quality criteria would also be acceptable. *See* NYSE Arca Vanguard Letter at 3, n.9.

[292] *See* NYSE Arca Vanguard Letter at 3, n.9.

[293] *See* NASDAQ Vanguard Letter at 5.

[294] *See* IR Letter at 2.

competitive forces will essentially render the MQP compulsory, forcing ETPs into a ''pay-to-play'' environment where new ETPs must pay for it to launch and existing ETPs must pay to maintain quality markets.[295] This commenter raises a similar concern for the Fixed Incentive Program.[296] Do commenters agree with this concern? Why or why not? If so, should the Commission be concerned with this outcome? Why or why not? How might ETPs that do *not* participate in a Program (even if they qualify for participation), for whatever reason, be affected by the Programs, if at all? For example, will market makers gravitate to the ETPs that participate and avoid those that do not participate, potentially rendering non-participating ETPs as funds with diminished market making activity? Under this scenario, even if the Programs have the desired effect of enhancing market quality for participating ETPs, might they have the unintended effect of diminishing market quality (widening spreads and limiting book depth) in non-participating ETPs? Why or why not? Or, could the Programs result in an unintended consequence of creating an over-supply of overall market maker services as a result?

12. More generally, is it possible for either Program to result in a prisoner's dilemma equilibrium, in which all eligible ETPs participate in the program and achieve limited benefits while paying higher fees? If so, how could the Programs be designed to prevent such an equilibrium? If not, why not? Are there other potential equilibria that these Programs should avoid and how could they be designed to avoid them? For example, would limiting the number of participating ETPs per fund sponsor, as proposed under the NYSE Arca Proposal, prevent the possibility of market makers pressuring ETP issuers to place every single listed ETP into the Program?

13. Two commenters voice concerns that LMMs in the Fixed Incentive Program would not have higher performance standards than LMMs not participating in the Fixed Incentive Program, and suggest that NYSE Arca impose higher performance standards on LMMs participating in the Fixed Incentive Program.[297] One commenter argues that requiring heightened performance standards to receive the Optional Incentive Fee would address conflict of interest concerns, may provide a greater incentive for LMMs to make better markets in ETPs, and would make the overall standards of the Fixed Incentive Program more transparent to issuers and investors.[298] Do commenters agree or disagree with this comment? Why or why not? Specifically, should NYSE Arca adopt higher performance standards for LLMs in the Fixed Incentive Program? Would this help to alleviate the concerns voiced by commenters over the NYSE Arca Proposal? Why or why not?

14. Under the NASDAQ Proposal, multiple market makers may compete for incentive payments under the MQP with respect to an MQP Security. Under the NYSE Arca Proposal, a single market maker (LMM) would be able to receive incentive payments under the Fixed Income Program with respect to a security in the program. How, if at all, would having multiple Market Makers competing for payments under NASDAQ's MQP impact the potential benefits of its program? How, if at all, would having only one Market Maker be eligible to receive payments under the NYSE Arca's Fixed Incentive Program impact the potential benefits of its program?

15. Under the NASDAQ Proposal, an MQP Company that wants to participate in the MQP must submit an application in the form prescribed by NASDAQ, which may limit the number of MQP Securities that such MQP Company may list in the MQP based on factors relating to current and expected liquidity characteristics of the MQP Securities, the projected initial and continued market quality needs of the MQP Securities, and the trading characteristics of the MQP Securities (*e.g.,* quoting, trading, and volume).[299] In addition, for an MQP Company to be eligible to participate in the MQP, NASDAQ must have accepted the MQP Company's application in respect of an MQP Security, the MQP Security must meet all requirements to be listed on NASDAQ, and the MQP Security must meet all NASDAQ requirements for continued listing at all times the MQP Security participates in the MQP.[300] Under the NYSE Arca Proposal, an issuer that wants to have an ETP participate in the Fixed Incentive Program must submit a written application in a form prescribed by NYSE Arca, provided that an issuer may not have more than 5 existing ETPs that are listed on NYSE Arca prior to the pilot participate in the Fixed Incentive Program.[301] In addition, to be eligible to participate, an issuer must be current in all payments due to NYSE Arca if it has other securities listed on NYSE Arca and must be current in all payments due to NYSE Arca and compliant with continued listing standards for the ETP proposed for inclusion if the issuer elects to participate in the Fixed Incentive Program after listing such ETP on NYSE Arca.[302] With respect to each proposal, do commenters agree that the applicable criteria defining participation eligibility for the ETPs are sufficiently objective and clear? If not, do the criteria raise concerns? If so, why, and if not, why not? Should the Programs establish additional criteria for participation for ETPs, other than those that are proposed? *If so, what criteria do commenters suggest, and why?*

16. Under the NASDAQ Proposal, the MQP Company would be paying the MQP Fee. The term ''MQP Company'' is defined as ''a fund sponsor or other entity that lists one or more MQP Securities on NASDAQ pursuant to the MQP.''[303] NASDAQ has indicated in the NASDAQ Response Letter that the entity paying the MQP Fee would be the ETF sponsor, rather than the ETF itself.[304] Under the NASDAQ Proposal, ETFs, TIRS and LSs could all qualify to be MQP Securities. Thus, while NASDAQ indicates that only ETF sponsors would be paying the MQP Fee, this only relates to ETFs, and does not apply to the TIRs and LSs, which may not have ''sponsor'' arrangements. Do commenters believe that the entity that would pay the MQP Fee under NASDAQ's proposal is sufficiently clear? If not, how would commenters suggest clarifying the definition of MQP Company as it pertains to each specific type of MQP Security?

17. Under the NYSE Arca Proposal, the Optional Incentive Fee for each ETP in the Fixed Incentive Program would be paid by the issuer.[305] The term ''issuer'' is not defined in the NYSE Arca Proposal or elsewhere in the NYSE Arca Equities Rules. Two commenters believe that it is unclear from NYSE Arca's Proposal whether the entity paying the Optional Incentive Fee would be the ETP sponsor or the fund itself. Do commenters believe that the entity that would pay the Optional Incentive Fee under NYSE Arca's proposal is sufficiently clear? If not,

[295] *See* NASDAQ Vanguard Letter at 4.

[296] *See* NYSE Arca Vanguard Letter at 2, n.7.

[297] *See* NYSE Arca ICI Letter at 3 and NYSE Arca Vanguard Letter at 3.

[298] *See* NYSE Arca ICI Letter at 3.

[299] *See* proposed NASDAQ Rule 5950(a)(1)(A) and (B).

[300] *See* proposed NASDAQ Rule 5950(b)(1).

[301] *See* proposed NYSE Arca Equities Rule 8.800(b)(1).

[302] *See* proposed NYSE Arca Equities Rule 8.800(b)(2).

[303] *See* proposed NASDAQ Rule 5950(e)(7).

[304] *See* NASDAQ Response Letter at 20.

[305] *See* proposed NYSE Arca Equities Rule 8.800(c)(1).

how would commenters suggest clarifying the proposal?

18. NASDAQ is proposing to disclose on its Web site the acceptance of an MQP Company and MQP Market Maker into the MQP; the total number of MQP Securities that any one MQP Company may have in the MQP; the names of MQP Securities and the MQP Market Maker(s) in each MQP Security; the amount, if any, of any Supplemental MQP Fee and the Quote Share Payment and Trade Share Payment allocation determined by each MQP Company; and any limit on the number of MQP Market Makers that are permitted to register in an MQP Security. NYSE Arca proposes to provide notification on its Web site of the ETPs participating in the Fixed Incentive Program and the LMMs assigned to such ETPs. Is it likely that investors and other market participants would consult the Exchanges' Web sites for information about which securities and market makers are participating in the Programs? Would investors be able to easily distinguish quotations for ETPs that are in the Program from those that are not? Why or why not?

One commenter suggests that, in addition to NASDAQ's Web site, participation in the MQP also should be noted on the MQP Security's Web site and in regulatory disclosure documents.[306] Do commenters agree or disagree with this suggestion? Why or why not? Is there a need for additional disclosure to provide information to investors about issuer participation in the Programs that would allow investors to make better informed investment decisions at the time of purchase of ETPs in the Programs, including the potential consequences if an ETP is no longer in the Programs?

One commenter suggests that a ticker symbol identifier would be useful for products in the MQP.[307] NASDAQ asserts in its response to comments that such an identifier is unnecessary and that it would be undesirable ''to brand MQP products through symbology'' because the MQP is designed to be transparent through information to be disclosed on the Exchange's Web site.[308] Would investors be able to easily distinguish quotations for ETPs that are in the Program from those that are not? If not, should the Commission be concerned about this? If the Commission should be concerned, would a ticker symbol identifier for securities in the Programs help to address this concern? Why or why not? Are there other potential solutions?

19. Under the NYSE Arca Proposal, an issuer participating in the Fixed Incentive Program would be required to pay the Optional Incentive Fee in an amount between $10,000 and $40,000, which amount would be negotiated between the issuer and the LMM assigned to such issuer's ETP, and the final amount of such Optional Incentive Fee would not be publicly disclosed. Should NYSE Arca be required to disclose the final amount of such Optional Incentive Fee? Would such information be helpful to investors in determining whether to invest in an ETP in the Fixed Incentive Program? Why or why not?

20. A commenter suggests that NASDAQ be required to make available the data gathered under the pilot to ETP sponsors participating in the MQP.[309] This same commenter also supports the view that, with respect to the Fixed Incentive Program,[310] NYSE Arca should be required to publicly (and anonymously) disclose statistics on the performance of LMMs in the Program, as such information could be meaningful for investors and would help assess how much liquidity is being provided by LMMs under the Program.[311] Another commenter suggests that NASDAQ publicly disclose on a monthly basis each MQP Market Maker's share of Quote Share Payments and Trade Share Payments for each MQP Security the MQP Market Maker quotes/trades.[312] Should the Exchanges be required to disclose the data gathered under the Programs to the issuers participating in the Program? Should such information be required to be publicly disclosed? Should the Exchanges be required to publicly disclose (on an anonymous basis or otherwise) the performance of the market makers participating in the respective Programs during the pilot period? Should the Exchanges be required to provide to the Commission and publically disclose any analysis of the impact of the Programs? Would some or all of this information be useful for investors? Would the public disclosure provide useful data to academics or other members of the public to help assess the impact of the Programs? Would such analyses provide useful information to the Exchanges or Commission to help assess whether the Programs were operating in a manner consistent with the Exchange Act and are consistent with the protection of investors? For each question, please explain your answer.

21. With respect to the NASDAQ Proposal, two commenters suggest improvements to the implementation of the pilot to allow the Commission and NASDAQ to more effectively assess the impact of the MQP.[313] One of these commenters suggests that the pilot have a staggered introduction of MQP Securities with a randomized sequence, and a long enough pre- and post-event period (*e.g.,* 3 months) for each introduction to identify an effect.[314] In the NASDAQ Response Letter, NASDAQ states that a staggered introduction of MQP Securities and a randomized sequence would add ''un-needed complexity to the program, and is not necessary in light of the optional nature of the MQP.'' [315] The same commenter also suggests that NASDAQ provide the Commission with detailed reporting of all trades and quotes in all securities for a pre-event period and a post-event period (with MQP Market Maker trades and quotes flagged).[316] Another commenter, however, notes that any ''before and after'' data needed can be obtained by comparing trading and asset growth in existing products which move into the MQP after it is launched, and a period after an ETF launch without participation in MQP would be an unnecessary and inappropriate handicap for new ETFs.[317] NASDAQ states its belief that any pre-event period would be ''antithetical to the goal of the program to enhance liquidity of products as soon as possible.'' [318]

Another commenter believes NASDAQ should be required to monitor market quality metrics during the pilot not only for ETFs participating in the MQP, but also for ETFs that do not participate in the MQP, to determine whether the non-participating ETFs are negatively affected.[319] With respect to the NYSE Arca Proposal, one commenter believes it is important that NYSE Arca and the Commission have an opportunity to evaluate the impact of the program on the quality of markets in ETPs prior to considering its permanent approval, both with respect to ETPs

[306] *See* ETF Consultants Letter at 8.

[307] *See* Weaver Letter at 9.

[308] *See* NASDAQ Response Letter at 7–8.

[309] *See* NASDAQ ICI Letter at 3.

[310] Under the Fixed Incentive Program pilot, NYSE Arca states that it would provide the Commission with certain market quality data on a confidential basis each month. *See* NYSE Arca Notice, *supra* note 12, at 29422.

[311] *See* NYSE Arca ICI Letter at 4.

[312] *See* ETF Consultants Letter at 8.

[313] *See* Menkveld Letter at 4–5 and NASDAQ Vanguard Letter at 4–5.

[314] *See* Menkveld Letter at 4–5.

[315] *See* NASDAQ Response Letter at 9.

[316] *See id.*

[317] *See* ETF Consultants Letter at 8.

[318] *See id.*

[319] *See* NASDAQ Vanguard Letter at 4.

participating in the program and those ETPs that choose not to participate.[320]

Do commenters agree or disagree with these views? Why or why not? Would the structure of each pilot as proposed, as well as the data or other information proposed to be provided to the Commission, sufficiently help inform the Commission as to whether the MQP or the Fixed Incentive Program, as applicable, was working as intended to achieve each Exchange's stated objective? Why or why not? For example, would the applicable Exchange or the Commission be able to fully evaluate a Program without being able to compare the performance of a particular ETP before it enters the Program with its performance once it has entered the Program? Why or why not? Should securities be eligible for the Programs only after trading for some period of time (*e.g.,* 3–6 months) without the benefit of participating in the applicable Program? In addition, would the structure of each pilot as proposed and the data or other information to be provided to the Commission allow the Exchanges and the Commission to adequately assess commenters' concerns? If not, how should each Exchange amend its respective pilot structure and/or data items or other information to improve the ability of the Exchange and the Commission to be able to adequately assess commenters' concerns? Similarly, would the proposed pilot structures and submission of data items or other information be helpful to the Commission in determining whether the Programs are operating consistent with the requirements of the Exchange Act and the rules thereunder? If not, how should each Exchange amend its respective pilot structure and/or data items or other information to improve the chances that the pilot would operate consistent with the requirements of the Exchange Act and rules thereunder?

22. In addition to the data items and/or other information that the Exchanges have proposed to provide to the Commission, should each Exchange also provide analyses of its respective pilot that addresses the intended impacts of its Program? Have the Exchanges adequately responded to commenters' concerns? If not, should the Exchanges be required to supplement the public file with additional data and analyses on the impact of the Programs? What specific issues should any such analyses cover? Should the Exchanges provide empirical support for these analyses?

23. Under the NYSE Arca Proposal, NYSE Arca would retain a 5% administrative fee to be deducted from the Optional Incentive Fee paid by the ETP issuer.[321] NYSE Arca states that this fee would be reasonable to cover its costs of administering the program.[322] What are commenters views on whether a 5% administrative fee charged by NYSE Arca for participation in its Fixed Incentive Program would be reasonable? Do commenters believe that NYSE Arca has clearly and sufficiently explained why this fee is reasonable? Also, do commenters have a view as to whether this fee would or would not impact the Exchange's incentives when administering the Program? If so, how so? If not, why not?

24. Are there any alternative means of addressing the concerns of Rule 102 of Regulation M, which could be conditions to exemptive relief from that provision? Please specify particular conditions that commenters believe would be appropriate to address the Regulation M concerns.

25. Do commenters believe the ''incubation'' period potentially provided by these Programs for newly listed ETPs will affect the decision making process of ETP sponsors concerning which ETP products to bring to market or not to bring to market? Why or why not?

26. Section 6(b)(8) of the Exchange Act[323] requires that the rules of a national securities exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. Both NASDAQ and NYSE Arca represent they do not believe that their respective Programs will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.[324] What are commenters views as to whether the Exchanges have sufficiently explained why their respective proposals do not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act?

27. NASDAQ states that the MQP would be beneficial to the financial markets, to market participants including traders and investors, and to the economy in general. First, the Exchange proposes the MQP to encourage narrow spreads and liquid markets in situations that generally have not been, or may not be, conducive to naturally having such markets. In NASDAQ's view, the securities that comprise these markets may include less actively traded or less well known ETF products that are made up of securities of less well known or start-up companies as components.[325] Second, in rewarding Market Makers that are willing to ''go the extra mile'' to develop liquid markets for MQP Securities, NASDAQ asserts that the MQP would clearly benefit traders and investors by encouraging more quote competition, narrower spreads, and greater liquidity. Third, NASDAQ asserts that the MQP will lower transaction costs and enhance liquidity in both ETFs and their components, making those securities more attractive to a broader range of investors. In so doing, NASDAQ states that the MQP will help companies access capital to invest and grow. And fourth, NASDAQ asserts that the MQP may attract smaller, less developed companies and investment opportunities to a regulated and transparent market and thereby serve the dual function of providing access to on-Exchange listing while expanding investment and trading opportunities to market participants and investors.[326] NYSE Arca states that the Fixed Incentive Program is designed to encourage additional market makers to pursue LMM assignments and thereby support the provision of consistent liquidity in ETPs listed on the Exchange, and further states that the assignment of an LMM is a critical component of the promotion of a consistent, fair and orderly market in ETPs on the Exchange.[327]

Do commenters agree or disagree with NASDAQ's and NYSE Arca's assertions as to the Programs' potential impact on efficiency, competition, and capital formation? Why or why not? Generally, do commenters have any other views as to whether and, if so, how each of the Programs would impact efficiency, competition, and capital formation? Do the proposed pilot structures, for example, promote efficiency, competition, and capital formation? Why or why not?

Comments may be submitted by any of the following methods:

[320] *See* NYSE Arca ICI Letter at 4.

[321] *See* NYSE Arca Notice, *supra* note 12, at 29421, n.12. NASDAQ does not propose any similar fee in its proposal.

[322] *See* NYSE Arca Notice, *supra* note 12 at 29422.

[323] 15 U.S.C. 78f(b)(8).

[324] *See* NASDAQ Notice, *supra* note 4, at 22050–51; NYSE Arca Notice, *supra* note 12, at 29423.

[325] *See* NASDAQ Notice, *supra* note 4, at 22043, n.12 (''These small companies and their securities (whether components of listed products like ETFs or direct listings) have been widely recognized as essential to job growth and creation and, by extension, to the health of the economy. Being included in a successful ETF can provide the stocks of these companies with enhanced liquidity and exposure, enabling them to attract investors and access capital markets to fund investment and growth'').

[326] *See* NASDAQ Notice, *supra* note 4, at 22043.

[327] *See* NYSE Arca Notice, *supra* note 12, at 29420, 29421–29422.

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an email to *rule-comments@sec.gov.* Please include File Numbers SR–NASDAQ–2012–043 and/or SR–NYSEArca–2012–37 on the subject line.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549–1090.

All submissions should refer to File Numbers SR–NASDAQ–2012–043 and/or SR–NYSEArca–2012–37. These file numbers should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the SRO Proposals that are filed with the Commission, and all written communications relating to the SRO Proposals between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filings also will be available for inspection and copying at the principal office of the Exchanges. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Numbers SR–NASDAQ–2012–043 and/or SR–NYSEArca–2012–37 and should be submitted on or before August 16, 2012. Rebuttal comments should be submitted by August 31, 2012.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[328]

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2012–17349 Filed 7–16–12; 8:45 am]

BILLING CODE 8011–01–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–67388; File No. SR–NASDAQ–2012–83]

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Customer Rebates in Penny Pilot Options

July 10, 2012.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 [2] thereunder, notice is hereby given that, on June 29, 2012, The NASDAQ Stock Market LLC (''NASDAQ'' or ''Exchange'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

NASDAQ proposes to modify Chapter XV, entitled ''Option Pricing,'' at Section 2 governing pricing for NASDAQ members using the NASDAQ Options Market (''NOM''), NASDAQ's facility for executing and routing standardized equity and index options. Specifically, NOM proposes to amend a Penny Pilot [3] Option Customer Rebate to Add Liquidity. The Exchange also proposes a minor technical amendment.

While the changes proposed herein are effective upon filing, the Exchange has designated these changes to be operative on July 2, 2012.

The text of the proposed rule change is available on the Exchange's Web site at *http://nasdaq.cchwallstreet.com,* at the principal office of the Exchange, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

NASDAQ proposes to modify Chapter XV, entitled ''Option Pricing,'' at Section 2(1) governing the rebates and fees assessed for option orders entered into NOM. Specifically, the Exchange is proposing to modify the five tier structure for paying Customer Rebates to Add Liquidity in Penny Pilot Options. The Exchange proposes to amend the qualifications for a Tier 4 Customer Rebate to Add Liquidity to further incentivize NOM Participants to route Customer orders in Penny Pilot Options to the Exchange by providing NOM Participants another means of achieving a certain volume criteria to qualify for a rebate. The Exchange believes that incentivizing NOM Participants to send additional Customer orders in Penny Pilot Options to the Exchange will benefit all market participants by adding liquidity to the market.

Specifically, the Exchange currently pays a Customer Rebate to Add Liquidity in Penny Pilot Options based on the following tier structure:

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[328] 17 CFR 200.30–3(a)(57).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] The Penny Pilot was established in March 2008 and in October 2009 was expanded and extended through June 30, 2012. *See* Securities Exchange Act Release Nos. 57579 (March 28, 2008), 73 FR 18587 (April 4, 2008) (SR–NASDAQ–2008–026 (notice of filing and immediate effectiveness establishing Penny Pilot); 60874 (October 23, 2009), 74 FR 56682 (November 2, 2009) (SR–NASDAQ–2009–091) (notice of filing and immediate effectiveness expanding and extending Penny Pilot); 60965 (November 9, 2009), 74 FR 59292 (November 17, 2009) (SR–NASDAQ–2009–097) (notice of filing and immediate effectiveness adding seventy-five classes to Penny Pilot); 61455 (February 1, 2010), 75 FR 6239 (February 8, 2010) (SR–NASDAQ–2010–013) (notice of filing and immediate effectiveness adding seventy-five classes to Penny Pilot); 62029 (May 4, 2010), 75 FR 25895 (May 10, 2010) (SR–NASDAQ–2010–053) (notice of filing and immediate effectiveness adding seventy-five classes to Penny Pilot); 65969 (December 15, 2011), 76 FR 79268 (December 21, 2011) (SR–NASDAQ–2011–169) (notice of filing and immediate effectiveness extending and replacing Penny Pilot); SR–NADAQ–2012–075 (not published) (notice of filing and immediate effectiveness extending and replacing Penny Pilot). *See also* Exchange Rule Chapter VI, Section 5.