

MEMO# 26189

May 24, 2012

NYSE Arca Proposal to Establish a Market Maker Incentive Program

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TO: ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 14-12
ETF ADVISORY COMMITTEE No. 12-12
CLOSED-END INVESTMENT COMPANY MEMBERS No. 27-12
EQUITY MARKETS ADVISORY COMMITTEE No. 9-12 RE: NYSE ARCA PROPOSAL TO ESTABLISH A MARKET MAKER INCENTIVE PROGRAM

NYSE Arca has filed a proposal with the SEC to establish the Lead Market Maker (“LMM”) Issuer Incentive Program (“Fixed Incentive Program”) for issuers of certain exchange-traded products (“ETPs”) listed on the Exchange. The most significant aspects of the proposal are discussed below. [\[1\]](#)

Fixed Incentive Program

The Fixed Incentive Program is a voluntary program designed to incentivize market makers to undertake LMM assignments in ETPs. Under the program, an issuer of an ETP could elect to pay NYSE Arca an “Optional Incentive Fee,” which would range from \$10,000 to \$40,000 per year, in addition to the currently applicable listing and annual fees. An issuer could elect to participate at the time of the ETP listing or anytime after that; an issuer, however, could not have more than five existing ETPs participate in the Fixed Incentive Program.

NYSE Arca would communicate the ETPs proposed for inclusion in the Fixed Incentive Program on a written solicitation that would be sent to all qualified LMM firms along with the Optional Incentive Fee the issuer proposes to pay NYSE Arca for each ETP. The issuer and the LMM would then agree on the final Optional Incentive Fee for each ETP. If more than one qualified LMM proposed to serve as the ETP LMM, the issuer would choose the LMM.

NYSE Arca would credit an LMM for the LMM payment, which would be equal to the Optional Incentive Fee paid by the issuer, less an NYSE Arca administration fee of 5 percent. An LMM that receives an LMM payment would not be eligible for “LMM Rates” for that ETP under NYSE Arca’s fee schedule while participating in the Fixed Incentive Program but would

instead be subject to “Standard Rates.” [\[2\]](#)

The pilot program would be offered to issuers from the date of implementation until December 31, 2013. The Release states that during the course of the pilot period, NYSE Arca would assess the Fixed Incentive Program and may expand the criteria for ETPs that are eligible to participate to, for example, permit issuers to include more than five ETPs that were listed on NYSE Arca before the pilot in the program. During the pilot program, NYSE Arca also would provide the SEC with certain market quality data on a confidential basis each month.

The Release states that NYSE Arca believes that the pilot program would not be inconsistent with FINRA Rule 5250, which prohibits payment for market making, as Rule 5250 is designed to address issues associated with securities of operating companies, and that such issues are not present with ETPs, which have derivative pricing, creation and/or redemption features, or upsizing that would preclude the type of manipulation that FINRA Rule 5250 is designed to prevent.

At the end of the proposal, the SEC requests comment on a number of issues relating to the Fixed Incentive Program including:

- Which factors explain the apparent increasing proportion of new ETPs that are listed on NYSE Arca without a designated LMM and whether the Fixed Incentive Program will incentivize more LMMs to take assignments in ETPs;
- What, if anything, does a lack of liquidity in an ETP indicate about the ability of an LMM or other market maker to make effective use of arbitrage and the creation/redemption mechanisms often associated with ETPs and how, if at all, would a market-making incentive program affect any intraday premium (discount) of the traded price of an ETP above (below) its intraday indicative value;
- Whether there are aspects of this type of incentivized market quality that should concern investors;
- Whether it is appropriate that under the proposal, LMMs for ETPs in the Fixed Incentive Program would continue to be subject to the current LMM performance standards and whether LMMs for ETPs in the Fixed Incentive Program should be subject to higher standards because of the LMM payments that they could be entitled to receive;
- Whether NYSE Arca should establish objective standards and be responsible for choosing the designated LMM for a particular issuer and ETP in the Fixed Incentive Program instead of allowing the issuer that has chosen to participate in the Fixed Incentive Program to choose the LMM;
- Whether it is appropriate to allow issuers and LMMs to negotiate the Optional Incentive Fee and whether this raises concerns regarding investor confidence, market integrity, and member standards;
- Whether the Fixed Incentive Program could have an impact (either positive or negative) on incentives for market making in other ETPs listed and traded on NYSE Arca that are not eligible for and/or do not participate in the Fixed Incentive Program;
- Whether it would be more appropriate for an ETP to be removed from the Fixed Incentive Program once it reaches a certain liquidity level or volume threshold and/or whether it would be more appropriate to limit inclusion in the program to newly listed or low volume ETPs; and
- Should NYSE Arca be required to publicly (and anonymously) disclose statistics on the performance of LMMs.

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endnotes

[1] The proposal can be found on the SEC's website at <http://www.sec.gov/rules/sro/nysearca/2012/34-66966.pdf>. Comments on the proposal are due to the SEC no later than June 7.

[2] The Release states that to incentivize firms to take on the LMM designation, NYSE Arca currently provides LMMs with an opportunity to receive incrementally higher transaction credits and incur incrementally lower transaction fees ("LMM Rates") compared to standard liquidity maker-taker rates ("Standard Rates").

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