COMMENT LETTER

August 16, 2012

ICI Letter on SEC Order Relating to Exchange Market Maker Incentive Programs (pdf)

August 16, 2012 Ms. Elizabeth M. Murphy Secretary U.S. Securities and Exchange Commission 100 F Street, N.E. Washington, D.C. 20549-1090 Re: NASDAQ and NYSE Arca Market Maker Incentive Programs (File Nos. SR-NASDAQ-2012- 043 and SR-NYSEArca-2012-37) Dear Ms. Murphy: The Investment Company Institute1 is writing to respond to the SEC order2 instituting proceedings to determine whether to approve or disapprove the proposed NASDAQ Market Quality Program ("MQP")3 and NYSE Arca Fixed Incentive Program ("Fixed Incentive Program")4 (collectively, the "Programs") – the exchanges' proposed market maker incentive programs. As we stated in our comment letters on the Programs when they were first proposed,5 as ETF sponsors, ICI members have a strong interest in ensuring that the securities markets are highly competitive and that the regulatory structure that governs the markets encourages liquidity, 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.1 trillion and serve over 90 million shareholders. 2 Securities Exchange Act Release No. 67411 (July 11, 2012), 77 FR 42052 (July 17, 2012) ("Release"). 3 Securities Exchange Act Release No. 66765 (April 6, 2012), 77 FR 22042 (April 12, 2012). 4 Securities Exchange Act Release No. 66966 (May 11, 2012), 77 FR 29419 (May 17, 2012). 5 See Letters from Ari Burstein, Senior Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated May 3, 2012 (NASDAQ MQP) and June 7, 2012 (NYSE Arca Fixed Incentive Program). The letters can be found on ICI's website at http://www.ici.org/pdf/26142.pdf and http://www.ici.org/pdf/26227.pdf. Ms. Elizabeth M. Murphy August 16, 2012 Page 2 of 4 transparency, and price discovery. We have therefore long advocated for regulatory changes that would result in more efficient markets for issuers of securities, and investors in those securities. Consistent with these goals, ICI continues to support the overall goal of the Programs - to incentivize market makers to make high-quality, liquid markets in ETFs. Liquid markets are critical for ETFs, particularly smaller and less frequently traded ETFs. We recognize, however, that the Programs raise several novel issues for the Commission to consider. Significantly, the Programs represent a departure from current rules precluding market makers from accepting payment from an issuer of a security for acting as a market maker - rules that were put in place to address concerns regarding investor confidence, market integrity, and whether such payments raise conflicts of interest between an issuer and the market maker for a security. As discussed further below, ICI reiterates the recommendations made in our previous letters on the Programs; the majority of ICI members believe that the SEC should approve the Programs on a pilot basis if the Programs are modified to reflect these recommendations. Some ICI members, however, continue to oppose the Programs and believe the SEC should not approve the NASDAQ and NYSE Arca proposals. ICI Recommendations As the Release discusses, while there are a number of similarities between the Programs, there also are a number of important differences in the manner in which the Programs will operate. Most significantly: (1) the Fixed Incentive Program does not limit participation based on liquidity levels or volume thresholds;6 (2) there are no additional or higher performance standards that a lead market maker ("LMM") under the Fixed Incentive Program must meet to become eligible to obtain additional payments;7 and (3) there are no objective performance standards for LMMs under the Fixed Incentive Program, i.e., LMMs and issuers are permitted to negotiate the specific additional fee to be paid by the issuer to the LMM and related performance standards to obtain the fee.8 We continue to believe these differences could raise potential conflicts of interest between an LMM and an issuer. To address these concerns, ICI reiterates the recommendations contained in our previous letters and believes that the SEC should approve the Programs only if the changes set forth in our recommendations are implemented. Most significantly: 6 Under NASDAQ's MQP, only exchange traded products ("ETPs") that have an average NASDAQ daily trading volume ("ATV") of less than 2,000,000 would be eligible for the program, and the MQP would terminate with respect to the ETP if the security sustains an ATV of 2,000,000 shares or more for three consecutive months. 7 Market makers participating in NASDAQ's MQP would be subject to higher performance standards than those applicable to market makers not participating in the MQP. 8 NASDAQ sets forth specific standards with which market makers must comply to obtain any additional fees. Ms. Elizabeth M. Murphy August 16, 2012 Page 3 of 4 • Additional Eligibility Criteria – NYSE Arca should limit the type of products permitted into the Fixed Incentive Program based on liquidity levels or trading volume requirements. • Higher Performance Standards - NYSE Arca should impose higher performance standards on LMMs participating in the Fixed Incentive Program. • Objective Performance Standards - NYSE Arca should establish objective performance standards for LMMs participating in the Fixed Incentive Program. We believe these recommendations would help address conflict of interest concerns and may provide a greater incentive for market makers to make better markets in ETFs. ICI members who oppose the Programs believe any fixes to the proposed parameters will be insufficient to address their overall concerns with market maker incentive programs. Significantly, these members are concerned that issuer payments to market makers could have the potential to distort market forces, the Programs could lead to diminished market making activity in ETFs that are ineligible, or choose not, to participate in the Programs, and the Programs could create a "pay-to-play" environment, effectively forcing issuers to pay the additional fees to maintain quality markets for their eligible ETFs. Implementing the Programs on a Pilot Basis ICI believes that it is critical that if the Programs are approved, they be implemented on a pilot basis. NASDAQ and NYSE Arca, as well as the SEC, must have an opportunity to evaluate the impact of the Programs on the quality of markets in ETFs prior to considering their permanent approval, both with respect to ETFs participating in the Programs and ETFs that choose not to participate. We therefore support provisions in the proposals that will require NASDAQ and NYSE Arca to provide information to the SEC during the pilot about market quality associated with the Programs to assist in the comparison of ETFs before and after they are in the Programs, as well as comparing ETFs participating in the Programs with those that do not participate, and provide information regarding the overall operation of the Programs themselves. * * * * * If you have any questions on our comment letter, please feel free to contact me directly at (202) 371-5408. Ms. Elizabeth M. Murphy August 16, 2012 Page 4 of 4 Sincerely, /s/ Ari Burstein Ari Burstein Senior Counsel cc: The Honorable Mary L. Schapiro The Honorable Elisse B. Walter The Honorable Luis A. Aguilar The Honorable Troy A. Paredes The Honorable Daniel M. Gallagher Robert W. Cook, Director Division of Trading and Markets Norm Champ, Director Division of Investment Management U.S. Securities and Exchange Commission

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