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Via Electronic Submission

May 3, 2012

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549-1090

Re: File Number SR-NASDAQ-2012-043
Release No. 34-66765
Nasdaq proposal to add new Rule 5950 (Market Quality Program)

Dear Ms. Murphy:

Vanguard appreciates the opportunity to provide the Securities and Exchange Commission (the "Commission") with our views on The NASDAQ Stock Market LLC's ("Nasdaq") proposal to add a new Rule 5950 that would implement a Market Quality Program ("MQP" or the "Program") on a one-year pilot basis (the "Proposal").[1] Under the Program, ETF sponsors and other "MQP Companies"[2] would be permitted to pay money to Nasdaq that in turn would be paid to market makers who meet certain criteria when publishing quotes and executing trades in the sponsor's designated ETFs. As of March 31, 2012, Vanguard was the sponsor of 64 ETFs with collective assets of approximately $205 million. Sixteen of those ETFs, with collective assets of approximately $7.4 billion, are listed for trading on Nasdaq.

Vanguard neither supports nor opposes MQP at this time. We view the Program as a significant market reform that requires deeper thought and more debate. MQP would materially change the way market makers are compensated, which has implications for investors and for listed companies that compete for market making services. Reforms of this magnitude should be implemented only after robust review and the opportunity for meaningful and informed comment by interested parties. The Commission published the Proposal in the Federal Register on April 12, 2012, with a comment due date of May 3, 2012. Although a 21-day comment period is standard for self-regulatory agency filings, and is usually sufficient for such filings since most are routine and non-controversial, this Proposal is different. It is neither routine nor non-controversial. It implicates public policy issues that are not, in our opinion, adequately

[1] *Self-Regulatory Organizations: The NASDAQ Stock Market, LLC; Notice of Filing of Proposed rule Change, as Modified by Amendment No. 1 Thereto* Exchange Act Release No. 66765 (April 6, 2012) (the "Proposing Release").

[2] In addition to ETF sponsors, other MQP Companies eligible to participate in the Program are sponsors of "Linked Securities" as defined in Nasdaq Rule 5710 and "Trust Issued Receipts" as defined in Nasdaq Rule 5720. Notwithstanding the eligibility of these other instruments, Nasdaq acknowledges that MQP "will predominantly, if not entirely, consist of ETFs." Proposing Release, at page 4.

addressed in the Proposing Release, and could possibly have significant unintended consequences. The 21-day comment period provided by the SEC for a change of this magnitude is insufficient, and we urge the Commission to allow more time for interested parties to submit comments.

A. The Commission and FINRA historically have prohibited issuer payments to market makers

U.S. markets currently operate under a long-established standard that market makers may not accept payment from the issuer or promoter of a security if that payment is for publishing a quotation or acting as a market maker for the security. This standard dates back to at least 1973, when the Commission staff refused to grant no-action relief to a broker who wanted to levy a "service charge" on an issuer to cover expenses incurred in entering quotations and making a market in the issuer's securities.[3] Shortly thereafter, in 1975, the National Association of Securities Dealers in a Notice to Members expressly prohibited members from accepting payment for market making activities. The NASD explained the rationale for its position as follows:

> [M]embers generally have considerable latitude and freedom to make or terminate market making activities in over-the-counter securities. The decision to make a market in a given security and the question of "price" are generally dependent on a number of factors including, among others, supply and demand, the firm's attitude toward the market, its current inventory position and exposure to risk and competition. The additional factor of payments by an issuer to a market maker would probably be viewed as a conflict of interest since it would undoubtedly influence, to some degree, a firm's decision to make a market and thereafter, perhaps, the prices it would quote. Hence, what might appear to be independent trading activity may well be illusory. In view of these and other factors, any arrangement whereby a member charges an issuer a fee for making a market or accepts an unsolicited payment from an issuer whose securities the member makes a market in raises serious question under the anti-fraud provision of the federal securities laws.[4]

In 1997, the NASD formally amended its rules to prohibit members from accepting payment for market making activities by adopting Rule 2460, now codified as FINRA Rule 5250. That rule 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."[5] The SEC release approving adoption of this rule contains a cogent summary of the rule's intent:

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[3] *Monroe Securities, Inc.* (SEC no-action letter, pub. avail. June 4, 1973). The Commission concluded that: "In our view your proposal raises serious questions under the federal securities laws; any attempt to implement such a plan would appear to be inadvisable."

[4] NASD Notice to Members 75-16 (Feb. 20, 1975).

[5] Nasdaq has a rule of its own (Rule 2460) that is substantially similar to FINRA Rule 5250.

> The Commission believes that the proposed rule change is designed to prevent fraudulent and manipulative acts, to promote just and equitable principles of trade, and to protect investors and the public. 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 other things, 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' quotation 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 position of the NASD and establishes a clear standard of fair practice for member firms.[6]

B. Any change to the historical standard must include safeguards that protect investors and the integrity of the markets

In an effort to address the concerns that underlie the prohibition on issuer payments to market makers, Nasdaq has proposed a number of safeguards around the Program. Vanguard believes these safeguards are important and applauds Nasdaq for including them. Among the most important of these safeguards, in Vanguard's view, are the following: a transparency requirement wherein Nasdaq will disclose on its website the identity of all ETF and market makers participating in the Program, 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 Program payments; and opportunity for multiple market makers to compete for payments on each participating ETF.[7]

Unfortunately, it is not clear whether these safeguards will be sufficient to overcome the presumption, based on a 40-year regulatory standard, 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." For example, given what we know about investor behavior, is it likely that investors would consult Nasdaq's website for information about which ETFs and market makers are participating in the Program? If not, then most investors would not be able to distinguish quotations that reflect true market forces from quotations that have been influenced by issuer payments. In addition, Nasdaq places great emphasis on the fact that payments from ETF

[6] Securities Exchange Act Release No. 38812 (July 3, 1997) (footnotes omitted).

[7] Vanguard also applauds Nasdaq for proposing the Program as a one-year pilot, with extensive monitoring of market quality metrics during the pilot, and for basing payments not only on quote activity, but also on actual trade activity resulting from those quotes.

sponsors will flow through Nasdaq itself and will not be paid directly to market makers.[8] Does this "safeguard" reasonably address the concerns that underlie Nasdaq rule 2460 and FINRA rule 5250? Both rules prohibit member firms from accepting any payment or other consideration, "directly or indirectly," from the issuer of a security for market making activities. Inserting Nasdaq between the issuer and the market maker makes the payment indirect, but does it change the dynamic and address the public policy concerns around these payments?

C. Specific areas of concern that merit attention and additional opportunity to comment

We wish to emphasize that, at this time, Vanguard neither supports nor opposes Nasdaq's Proposal. Rather, we believe that MQP constitutes a significant market reform whose implications have not been fully explored. As a result, we believe a longer comment period is warranted in order to give market participants and other interested parties sufficient time to consider the myriad issues raised by the Proposal. Following are several specific questions, concerns, and observations about MQP that could benefit from additional public input and that we urge the Commission to consider before approving the Proposal:

1. What effect will the Program have on ETFs that are ineligible to participate or that are eligible but choose not to participate? Will market makers gravitate to the ETFs that participate and away from those that don't, potentially rendering non-participating ETFs as "orphan" funds with diminished market making activity? Under this scenario, even if the Program has the desired effect of enhancing market quality for participating ETFs, might it have the unintended effect of diminishing market quality (widening spreads and limiting book depth) in non-participating ETFs?[9]
   - If the Proposal is approved, Vanguard strongly urges the Commission to require Nasdaq to monitor market quality metrics during the pilot not only for participating ETFs, but also for ETFs that do not participate in the Program to determine whether they are negatively affected by their non-participation.

2. In light of the concerns expressed in the foregoing paragraph, will competitive forces effectively render the Program, which ostensibly is voluntary, compulsory? Does the Program put ETF sponsors into a "pay-to-play" environment where they must pay up to launch and list new ETFs or to maintain a quality market for their eligible ETFs?

[8] "[Nasdaq] stands between an MQP Company and an MQP Market Maker. An MQP Company cannot and does not, under any circumstances, pay any funds to an MQP Market Maker that makes a market in the MQP Company's product pursuant to the Program. This is crucial." Proposing Release, at page 19.

[9] In this regard, we note the provision in each federal securities law that "whenever . . . the Commission is engaged in rulemaking and is required to consider or determine whether an action is consistent with the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

3. In light of the concerns that historically have accompanied issuer payments to market makers, should the scope of the Program be narrower? Nasdaq positions the Program as intended to help "less actively traded" and "less well known" ETFs.[10] Yet the proposed eligibility criteria would permit any ETF with average daily trading volume of up to two million shares to participate. Of the 1,226 ETFs that existed as of March 31, 2012 (not all of which are listed on Nasdaq), Vanguard estimates that well over 90% would meet the eligibility criteria of the Program. The Commission should consider whether a lower trading volume threshold is more consistent with the stated goals of the Program as well as the public interest.[11] Alternatively, the Commission might consider whether Program eligibility should be (a) based on a metric other than trading volume that better measures market quality for an ETF, such as actual quotation and/or transaction data (because low trading volume does not necessarily mean low market quality), or (b) restricted to newly created ETFs, as discussed in the next paragraph.

4. Would the public interest be better served if there was a time limit on an ETF's participation in the Program? At its core, the Program represents a subsidization of ETFs that on their own are unable to generate much trading volume. This raises the question of whether products for which there is limited demand should be artificially propped up rather than allowed to fail (or simply to trade at a wider spread). One might justify such subsidization for a newly created ETF, giving it a reasonable opportunity to "gain traction" in the marketplace. But is there a justification for continuing that subsidization indefinitely? The Commission should consider whether to limit an ETF's participation in the Program to a defined period of time, say one or two years.
    - What are the implications for investors who purchase an ETF when it is in the Program but sell after the applicable time period has expired and the ETF is removed from the Program? Should investors be warned that in those circumstances spreads might widen considerably?

5. NYSE Arca recently submitted to the Commission a proposed rule change to implement a program similar to Nasdaq's MQP, but the details of the two programs are materially different. Because both proposals raise similar regulatory issues about the appropriate scope for permitting issuer payments to market makers, we believe the Commission should consider the two proposals together and not in isolation. This would allow commenters to compare and contrast the exchange's different approaches and help the Commission determine if one approach (or selected aspects of each proposal) better serves the public interest.

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[10] "[Nasdaq] 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. 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." Proposing Release, at page 5.

[11] For example, if the threshold were lowered from 2 million shares to 100,000 shares, we estimate that about 70% of ETFs would meet the eligibility criteria; at 50,000 shares the figure drops to about 60%.

6. Based on the definition of "MQP Company" in proposed Rule 5950(f), we assume that the Program will be financed by payments originating from ETF sponsors. However, footnote 5 of the Proposing Release notes that the term "Company" is defined in Nasdaq Rule 5005(a)(6) as the issuer of a security listed or applying to list on Nasdaq. The issuer of an ETF share is the ETF itself, not the ETF sponsor. For the avoidance of doubt, the Commission should require Nasdaq to clarify who would pay the Program fees. If it is the ETF rather than the ETF sponsor, the Proposal should be republished for comment as this would change the entire financial dynamic of the Program, requiring existing ETF investors to pay for enhanced liquidity.

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Thank you for the opportunity to comment on the Nasdaq Market Quality Program proposal. If you would like to discuss these comments further, please contact Barry Mendelson (610-503-2398) in Vanguard's Legal Department.

Sincerely,

/s/

Gus Sauter
Managing Director and Chief Investment Officer

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
Eileen Rominger, Director, Division of Investment Management
Robert Cook, Director, Division of Trading and Markets
Barry I. Pershkow, Senior Special Counsel (ETFs)