4/26/2012

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE
Washington DC 20549-1090

RE: SR-NASDAQ-2012-043

Dear Ms. Murphy:

We are registering opposition to The NASDAQ Stock Market's proposed Market Quality Program (MQP; SR-NASDAQ-2012-043) that would create new exchange Rule 5950 authorizing order-flow payments from ETF sponsors to market makers in thinly traded ETFs.

We are an analytics firm that provides mathematical market intelligence on trading behaviors to publicly traded companies. As a leading market-structure advisory firm serving many top issuers in US markets, our unique perspective reflects the interests of public companies in forming capital and quantifying equity-markets behavior.

To begin, we acknowledge and appreciate the NASDAQ's interest in promoting revenue and profit drivers. It's a public company. At the same time, it has fiduciary duties to distinct constituencies with disparate interests.

We have two principal objections to this proposal. ***First, the statutory basis offered by the exchange does not comport with the program's objective.***

One woe of the rule-filing mechanism is that exchanges make obligatory reference to language from the Securities and Exchange Act of 1933-34 as amended, now United States Code Title 15, Section 78f, while often proposing rules that contradict the language.

The purpose for referencing the Act is to substantiate comportment between rule proposals and governing regulation. Not to go through motions of quoting law so that the requirement might be scratched off the list. By the same token, the job of the Commission is to uphold the law. Not to check to see if the exchange has referenced it.

The Exchange offers this statutory basis:

NASDAQ believes that the proposed rule change is consistent with the provisions of Section 6 of the Act, in general, and with Sections 6(b)(4) and 6(b)(5) of the Act, in particular, in that it provides for the equitable allocation of reasonable dues, fees and other charges among members and issuers or Companies and other persons using any facility or system which NASDAQ operates or controls, and it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest.

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How does a proposal authorizing ETF sponsors to pay market-makers for making markets in a distinct and narrow set of securities promote equitable allocation of reasonable dues, fees and other charges among members and issuers or Companies and other persons using systems? It's the opposite of equitable allocation. Equitable allocation by definition means "apportioned equally."

How does a proposal that conjures volume and prices through deliberate, systematic interference with market mechanisms match a requirement that rules promote just and equitable principles of trade – meaning EVERYTHING AND EVERYONE IS TREATED THE SAME WAY?

How does a rule designed to manipulate behavior through payments – which would constitute a racketeering felony in both government and the private sector – comport with the instruction that rules should **remove** impediments and perfect the mechanism of a free and open market? Impediments to free markets consist of rule-constructions that prompt behaviors that would not occur by themselves.

Granted, perfecting mechanisms of free and open markets is inherently contradictory because a market cannot be both free and open and at the same time deliberately perfected ("perfected" subject to definition by the small group of persons responsible for the perfecting acts).

What's more, durable markets cannot be constructed on prices contrived through payment for order flow, or through any system in which the act of creating prices is profitable by itself. Incentivized trading obfuscates true supply and demand by creating volume where no natural buyers or sellers exist.

Market makers of old were middle men committing capital and taking risk for the opportunity to buy low and sell high. Intermediation proposed under the MQP carries little risk for intermediaries, who profit simply through participating. The market deriving from such complex exemption-oriented incentives, contrary to the language of the Act, is harmful to public companies, which seek investors willing to take risk over time. Under the MQP, money can behave transiently for temporal gains in ways not possible through trading other securities, and without connection to corporate business fundamentals.

And should it not be incumbent upon sponsors to create ETFs that attract interest? That's how it is for public companies, which must properly labor to differentiate their shares – already a task made herculean by the absurd "maker/taker" model and the explosion of derivative alternatives to holding equities. The resulting market is rife with volume chaffed by intermediaries that give public companies and investors a false sense of security about liquidity and natural participation in markets.

Finally, the argument isn't made meritoriously but by twisting regulatory language to fit the proposal. Had the NASDAQ said: "There's too much competition for data and transactions in the most heavily traded ETFs. We want to create a program for trading in neglected ETFs, and by extension in other securities, so we can profit on transactions and data," the argument could be weighed on its merits. Instead, the 82-page rule filing is a corpulent missive hoping to dissuade us from the basic truth: The exchange wants to spread statistical arbitrage further down market strata to help its best customers while generating profits for itself.

Unless the Commission wishes to publicly dismiss the purpose of our capital markets – capital formation – then this folly should be summarily rejected.

Second, the MQP will increase statistical arbitrage, which is not investment activity or capital-formation but speculative, short-term trading.

ETFs do not rise and fall with demand. They swell or contract. What happens when trading is promoted in products that swell or contract while others such as indexes and individual equities rise and fall? Arbitrage –

probability-based trading predicated not on appreciation or declines in share prices, but on divergence – increases.

We'll explain. ETFs are derivatives that track indexes and which may be comprised of the index's components, cash and other derivatives. As the Commission knows, since it reviews and approves prospectuses, ETFs depend on the create/redeem process. If demand for ETF shares exceeds liquidity, authorized participants may manufacture more in blocks of ETF shares called creation units. ETFs swell to absorb demand or contract as money leaves, keeping each aligned with its underpinning index – but making ETFs ideal vehicles to spur index arbitrage.

The authorized participants for ETFs nearly always consist of large broker-dealers and traders – top customers at exchanges – and big institutional investors, such as Blackrock, Vanguard and other proponents of ETFs and indexes. The constitution of units is supposed to comport with the ETF's model and the index that underpins the ETF, but with provision for substitutions. Authorized participants may assemble components by buying them in the open market, getting them from inventory or from large brokers, swapping for them – or substituting them with cash or derivatives.

Authorized participants can fluidly move on a daily basis or sooner when needed, from ETFs to components. Authorized Participant A could buy the futures and options of indexes and components, substituting cash for thinly traded components, create units, and profit on any small subsequent move. Then it could repeat the process in reverse. Authorized participants, or their clients, can thus always stay a step ahead of the broader market, and can position themselves to benefit from directional change. Nowhere in the NASDAQ's entire 82 pages of writ is there reference to ETF "authorized participants," the distinguishing feature of ETFs and the linchpin of their appeal as arbitrage vehicles.

Put simply, the ETF structure encourages daily rebalancing and discourages commitment of risk-capital over time – which is what public companies seek. And the ETF structure is a boulevard to routine statistical-arbitrage profits between ETF futures and options and index futures and options.

At a more sophisticated level, mathematical models could identify which index components comprising an ETF should be added in fractional proportion to ETF units, and which should be substituted in the form of cash so that those components may be bought or sold for arbitrage profit in dark pools or at displayed markets with minimal capital commitment. The possibilities are nearly infinite.

This is not investment. It does not focus investors on time-horizons commensurate with corporate business objectives. It does not enhance fundamental interest in stocks. It does not improve liquidity – which cannot be improved by fiat in ANY other segment of the market outside of ETFs, which alone can create and destroy liquidity at whim.

It's a wonder that ETFs are legal. Traders using probability-based analysis are certain to profit from this mathematical fact involving ETFs: ETFs track indexes and expand or contract units to match supply and demand, while the related securities, ranging from equity and risk swaps, to futures and options, to individual stocks, will vary based on supply or demand. Imagine buying a basket of similar ETFs and trading related indexes with varying degrees of passivity or aggression to capture small divergences.

One need not imagine; it's a key component of daily volume. This is statistical arbitrage, refined to art through ETFs. The NASDAQ now wishes to propagate this statistical-arbitrage model from mainstream ETFs into the market's untouched corners.

But the Act expressly prohibits promoting the interests of some market participants over those of others, and the exchange has a fiduciary and regulatory duty to serve all its constituents; promulgating its own profit drivers or the desires of its largest customers at the expense of capital-formation for issuers would be wrong. Arbitrage is not investment and does not promote capital-formation.

Again, we appreciate the NASDAQ's motivation. The number of public companies has declined from about 7,500 in 1998, to about 3,700 now in the National Market System (and falling), while ranks of ETFs have exploded from none to roughly 1,400. Most ETFs are sponsored by the exchange's top customers. It follows that the sort of cabal that inadvertently forms from this construct would seek its own interests. But just because public companies aren't part of the market's modern "inner circle" does not mean their shares should become, with Commission approval, chattel for arbitrage profits in derivatives.

We recognize too that under Dodd-Frank, the Commission is reliant on Section 31 fees for funding. It may be tempting to approve rules that foster more transactions – even ones like the MQP that are unabashed attempts to propagate profits from statistical arbitrage. But it's not good policy.

Concluding and reiterating, the rule does not by any measure promote fair and equitable markets. It does not comport with the language the exchange offered from statutes as basis. And it's detrimental to the interests of public companies, which do not benefit from markets metered by rules-driven arbitrage.

Public companies and investors are cornerstones of healthy markets. Yet rules filed by exchanges have produced a structure crafted around what's best for exchanges and their top customers, intermediaries driving contrived prices and contrived volume.

We need less of that, not more. Please reverse this trend by disapproving this rule.

Yours very truly,

Timothy Quast
Managing Director