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Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
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I am the author of *The Exchange-Traded Funds Manual, Second Edition*, Wiley, 2010 and the Managing Member of ETF Consultants LLC. ETF Consultants provides consulting services to ETF sponsors, index publishers, exchanges, investment managers and others in connection with the creation, management, marketing, trading and selection of exchange traded investment products such as exchange traded funds (ETFs), exchange traded notes (ETNs), securitized futures funds (SFFs) and other traded products for which a net asset value (NAV) is periodically calculated. In these comments I will follow industry practice by referring to these financial instruments collectively as exchange traded funds or ETFs.

General Comments

It is a pleasure to comment on a rule proposal that I feel will (1) make a substantial contribution to improving the quality of ETF trading markets and (2) facilitate trading in improved ETFs as new products are introduced.

NASDAQ's proposed rule addresses the major trading cost obstacle that small and new ETFs encounter when they enter a market dominated by benchmark index and "commodity" ETFs that

trade actively and on narrow spreads, partly because many established ETFs are linked to an arbitrage complex. For example, the S&P 500 SPDR is not large and actively traded because it offers a superior experience to investors. 500 SPDR trading activity is dominated by arbitrage transactions where, for example, a market participant might offset the risk in a long position in the SPDR with a short position in the S&P 500 futures contracts – or vice versa. Arbitrage activity in S&P 500 linked instruments helps assure low cost trading in the fund's shares for all investors. Lower trading costs attract more investors to this ETF than would be attracted solely by the quality of the investment experience it offers. Low cost trading is often not available today for an ETF based on an obscure index where arbitrage trading does not exist.

The introduction of the NASDAQ market quality program (MQP) will provide important incentives to attract market makers to participate in the introduction and continuous trading of newer, less immediately popular, ETFs. Many new and small ETFs may be (and in some cases almost certainly are) more attractive as investments than some of the larger, established ETFs based on benchmark indexes where investors are burdened by substantial costs associated with transparent index reconstitutions and rebalancing of the underlying portfolios. The cost of trading shares of these large funds may be as little as a few basis points. The internal portfolio trading costs of the benchmark index ETFs is typically unexamined by investors. They look at the bid/asked spread in the ETF shares and they see wider spreads in small and new funds.

The cost to trade many of the smaller and newer ETFs is unpredictable. Furthermore, the cost to trade these shares may be very large at times unless a way is developed to provide incentives to market makers. Such incentives do not exist under current market rules. The NASDAQ MQP is an attractive and low cost way to assure that market making services will be available to investors in newly introduced ETFs.

Typically, there is no link between the quality of the investment experience delivered by an ETF and the cost of trading the ETF shares – and there is no reason to expect such a linkage. However, ETF sponsors and the Exchanges they select for ETF listings need to assure reasonably continuous market making under terms that make it possible for investors to buy ETF shares without concern that it may not be possible for them to sell the shares at a price close to

the net asset value of the fund shares when they decide to sell. The issue is the spread, not that trading in every ETF must be recorded in millions of shares per day.

I am particularly impressed with the fact that the market making incentives provided by the proposed NASDAQ rule *do not affect the likely price of the fund shares* materially. The market maker's incentive is to post reasonable quotes, post them consistently and post quotes that an investor can trade with. The mid-point of the price range will be determined by market forces, not by a market maker's activity. There are incentives for the market maker to make the spread tighter because he will be compensated in part for the quality of his quotes and in part for participation in trading – by actually providing liquidity to investors. There is no incentive in the MQP for the market maker to be a consistent buyer or accumulator of the fund shares. In fact, there is no incentive whatever for the market maker to maintain an inventory of the ETF shares. The rule structure virtually assures that there will be a two-sided market when the investor arrives to buy shares in an ETF and a similar two-sided market will be there when an investor returns to sell. Market makers will receive payments *only* when they maintain a quality market (quotes) and when they provide actual liquidity to buyers and sellers (trades).

I am also impressed by the fact that implementation of this rule will not do much to help a small fund with an unappealing portfolio or a history of poor performance. It can make a satisfactory ETF product economically feasible by providing a fair market for an investor who has decided that the ETF meets her needs. It provides reasonable assurance that she will not be party to a one way trade where she might get in at a reasonable cost, but will find it virtually impossible to get out on similar terms.

An observation on the economics of the MQP for investors and fund sponsors seems appropriate. One of the topics where the commission specifically requests comments is: Who will pay for the MQP? I believe that the nominal incidence of MQP costs is relatively unimportant. If the payment to NASDAQ (for pass on to the market makers participating in the program) is nominally made by the fund, it will be reflected in the fund's expense ratio. If it is nominally paid by the fund sponsor, that fund sponsor will expect to recoup this cost element out of fees charged investors over time.

When one considers that the minimum cost of an MQP program for a new fund is $50,000 a year, this would be 1% of the assets of a $5M ETF annually. Adding one percent to the expense ratio of a fund would be impossible from a marketing perspective. Most fund sponsors will absorb this fee either through a cap on the expense ratio or by paying the fee themselves and expecting to recover it from their management fee over time. As long as the cost of the MQP affects the fund's annual expense ratio either from the start or over the long term, market forces should assure that investors will evaluate the costs and benefits of the MQP program on their fund experience appropriately.

Comments on Specific Points Highlighted by the Commission

I have not commented on specific points where my comments are not strongly felt or where I concur with other commenters.

1. Once an operating company goes public, it has presumably obtained a level of financing that its management deems adequate for initial operations. The quality of the secondary market in an operating company's shares may or may not be important until a time in the future when the company needs additional financing. In the launch of an exchange traded fund or similar product there is usually no underwriting process and the fund will often be launched without enough initial investment to permit the fund to operate profitably for the fund sponsor. The success of the ETF will depend in large part on additional investors entering the fund. ETF investors are not accepting a share in the risk of the success of an operating company. If they are unable to sell their fund shares at a price related to the value of the ETF portfolio, they are not getting the fair and orderly market they have the right to expect. In these contexts, I believe the MQP will prove more important for ETFs than for operating companies.

4. While there are numerous instances where the average degree of liquidity of the component positions in an ETF portfolio is quite different from the liquidity of the shares of the ETF, the portfolio and ETF share liquidities do tend to be correlated. With the exception of major benchmark index ETFs and other actively traded ETFs that make regular appearances on the

"Most Active Stocks" list in the *Wall Street Journal*, I would expect the MQP to be much more significant (both initially and on an ongoing basis) for ETFs than for operating companies. Most ETFs start very small and their size is unpredictable. Liquidity in newly introduced ETFs going forward will rarely be enhanced by being part of an arbitrage complex. Most important indexes and commodities where arbitrage will enhance ETF trading are already fully represented in the ETF market. In general, a comparison of the daily volume in today's most actively traded ETFs with the value of their assets indicates that the trading volume in the larger ETFs, such as the 500 SPDR, is disproportionately greater relative to assets than the volume in less actively traded ETFs which stand to benefit most from MQP. For example, in 2010, the median ETF in the U.S. had $91 million in assets and the largest ETF (the S&P 500 SPDR) had $91 billion in assets. The median fund traded about $1 million worth of shares per day while the 500 SPDR traded about $24 billion worth of shares per day. Turnover of the median fund was about 400% over the course of the year while the capitalization of the 500 SPDR typically turned over in less than 4 days. These data and other useful analysis of ETF trading can be found in "Inefficiencies in the Pricing of Exchange-Traded Funds" by Antti Petajisto available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572907.

I see no generic or intrinsic downside in NASDAQ's MQP. If a fund is not viable, MQP alone will not save it. If MQP is offered for a fund that ultimately proves unsuccessful, MQP will at least reduce investors' trading costs.

5. This question highlights the importance of the MQP in a market where incentives for market makers to participate actively and consistently in the market making function have largely disappeared. If no one is trading the exchange traded product and there are no relevant bids and offers, arbitrage will not occur. The MQP will encourage a market maker to be a continuous participant in the market and to look for links and arbitrage opportunities between and among the underlying portfolio and the exchange traded product. If investors are attracted, the spreads will narrow and volume will increase more than proportionately to the incentives. Under the Supplementary Fee Program, the ETF sponsor may adjust support incentives from the quote spread to trading participation or vice versa. The fund sponsor is the party with the most

knowledge and the most at stake in the trading success of the ETF, so this is an appropriate allocation of this responsibility.

6. The incentives offered to the market maker combine incentives to post a marketable quote and incentives to actually provide liquidity by being on the other side of an investor's trade. In order to be compensated in a significant way the market maker will certainly have clear economic incentives from the MQP payments to make tighter quotes than the thresholds required for qualification and in "greater quoted size".

8. To the extent that a market maker is committed to MQP, I believe that in two markets which are otherwise similar in the characteristics cited, the MQP market with at least one committed market maker will be more robust in an adverse environment than the market without MQP incentives. This will be a topic for interesting academic analysis when MQP is in place for some ETFs and not for others.

9. The proposed rule deals adequately with concerns about issuers paying market makers to provide quotes and liquidity. There is clearly nothing in the rule that encourages the market maker to hold a net position or to influence the *price level* of the shares. An attempt to push up the market price would be self-defeating by the nature of these products where net asset value proxies are provided frequently during trading hours. An attempt to push prices up or down artificially would be doomed by the availability of this information. The presence of more investors and other market participants as a result of the existence of MQP would put a spotlight on any such manipulative effort. As Justice Brandeis wrote, "sunshine is said to be the best of disinfectants".

10. The nature of the rule and the behavior for which the market maker is compensated, discourage inappropriate behavior by the market maker. The standards for each MQP implementation are precise. All parties, including investors, should be comfortable with the playing field as both level and more effectively groomed than the current "unimproved" market.

12. Permitting MQP issuers to pay the additional supplemental MQP fee at their discretion and to determine how to allocate the supplemental MQP between quotation and trading performance is appropriate. The quote standards are not necessarily "right" for every product. For example, the quote requirement for a fund holding large-cap equity securities which trade regularly at $.01 per share spreads will be of limited effect once volume reaches reasonable levels and the natural level of bids and offers is closer to the mean of the NBBO than the MQP quote standard. The interaction of the market maker and other market participants will certainly tighten the spread in this instance and the consistency with which the market maker participates in transactions by providing liquidity will be much more important. One size may be good enough for all in the initial phase; but, once the market is operating effectively, the change to permit the issuer (who has the greatest financial stake in the quality of the market) to determine the allocation is appropriate.

13. See General Comments.

14. There seems no compelling reason to require separation of the market making function and the creation/redemption function, though these functions are often performed by separate entities in today's marketplace.

15. There is no doubt in my mind that an ETF participating in the MQP will usually have a substantial market quality advantage over a comparable product that is not eligible for or does not participate in MQP. If I were a fund sponsor I would certainly want to participate in MQP.

16. I do not understand how any specific level of trading volume or any specific level of assets under management could be selected as an appropriate basis for discontinuing the MQP program. The absence of *any* other effective market making program in most ETF markets today suggests that any arbitrary rule for MQP discontinuance would be inappropriate. See No. 17.

17. Discontinuance of MQP could certainly have unintended consequences on fair and orderly markets unless the market maker is certain to continue to trade the shares without MQP compensation. The incentive payment might be an inconsequential amount for everyone

involved if the fund is successful in gathering assets. Specifically, the maximum MQP fee of $100,000 annually would be equal to a single basis point on a $1B fund. The insurance that payment provides in the event of market turmoil is worth that modest cost.

18. Unless the Commission or the Exchange comes up with a better mechanism to incent market makers appropriately and effectively, I doubt anyone will want to suspend or terminate MQP at the end of a year. The one year period is certainly a reasonable period over which to assess the impact of the rules. I believe the Commission, the Exchange, ETF issuers and Investors will all find the program extremely attractive within that time period.

19. If MQP is in operation, I cannot conceive of anyone wanting to launch a new ETF without MQP, essentially from the start. Any "before and after" data needed can be obtained by comparing trading and asset growth in existing products which move into the MQP program after it is launched. A period after an ETF launch without participation in MQP would be an unnecessary and inappropriate handicap for new ETFs.

21. Traditional methods of public notice appear to be adequate. MQP participation certainly should be noted on the ETF website and in regulatory disclosure documents. A knowledgeable fund issuer will recognize the value of making this information available.

23. This is an interesting question. ETF sponsors who are looking to engage MQP market makers will certainly want to know something about the record of eligible market makers in trading other products, some of which may be similar to their product. Anonymous disclosure would not be useful for this purpose and it is difficult to see how unanalyzed disclosure would permit a fair comparison of MQP participants. A good starting point would be as simple as monthly disclosure of how much each market maker receives for "quotes" and for "trading" from each MQP issue the market maker trades.