ES/42/136

NASDAQ OMX

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July 6, 2012

Ms. Elizabeth M. Murphy
Secretary
US Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: File No. SR-NASDAQ-2012-043; Release No. 34-66765

Dear Ms. Murphy:

This is in response to comments received in connection with the Securities and Exchange Commission's (the "SEC" or "Commission") review of rule filing SR-NASDAQ-2012-043 (the "Filing"), as amended.[1] The Filing proposed by NASDAQ OMX LLC. ("NASDAQ" or "Exchange") would create a voluntary Market Quality Program ("MQP" or "Program"). The MQP would enable market makers that voluntarily commit to and do in fact enhance the market quality, in terms of quoted spreads and liquidity, of certain securities listed on the Exchange to qualify for a fee credit. These market makers would be eligible for a fee credit only to the extent that they maintained stringent quoting and liquidity standards set forth in the Program. The MQP is proposed as one year pilot, during which time the Exchange will periodically provide information to the Commission about market quality in respect of the MQP. NASDAQ believes that the MQP will be beneficial to issuers, investors and other market participants, and to the economy in general by significantly enhancing the quality of the market and trading in listed securities.

The great majority of commenters that submitted letters to the Commission regarding the Filing clearly recognize the benefits of the MQP. These commenters urge the Commission to approve the MQP.

There is a vital need for the MQP in the U.S. market for products facing liquidity challenges. The Exchange proposes the MQP on a pilot basis in an effort to address this liquidity

[1] Securities Exchange Act Release No. 66765 (April 6, 2012), 77 FR 22042 (April 12, 2012)(Notice of Filing of Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to Establish the Market Quality Program 2012)("Notice").

gap.[2] As the Exchange noted in the Filing, the Exchange is proposing the MQP for several reasons.[3] First, to encourage narrow spreads and liquid markets in situations that generally have not been, or may not be, conducive to naturally having such markets. Second, to reward market makers that are willing to "go the extra mile" to develop liquid markets for securities listed pursuant to the MQP, and thereby benefit traders and investors by encouraging more quote competition, narrower spreads and greater liquidity. Third, to lower transaction costs and enhance liquidity in both ETFs and their components,[4] making those securities more attractive to a broader range of investors; which, we believe, will help companies access capital to invest and grow. And fourth, to attract smaller, less developed funds, companies and investment opportunities to a regulated and transparent market and thereby serve the dual function of providing access to on-Exchange listing while expanding investment and trading opportunities to market participants and investors.

The need for liquidity in the U.S. markets has been recognized at the highest levels of the U.S. government. Rep. Patrick McHenry (R-NC), member of the House Committee on Governmental Reform and Oversight, for example, has noted that agreements between issuers and market makers to pay for market making activity "...would allow small companies to produce an orderly, liquid market for their stocks. Research has shown that these agreements, already permitted overseas, have led to a positive influence on liquidity for small public companies."[5] Subsequent to the filing of the MQP proposal, Rep. McHenry developed legislation regarding market quality incentives, entitled "Liquidity Enhancement for Small Public Companies Act."[6] At the initial session of the Hearing on the U.S. Equity Market Structure before the House Financial Services Subcommittee on Capital Markets and

[2] The Exchange has been publicly expressing its concern about liquidity in the U.S. markets in various forums. See, for example, Testimony of Eric Noll, Executive Vice President, NASDAQ OMX Group, before the House Committee on Oversight and Government Reform, November 15, 2011.

[3] Filing, p. 3 of 17.

[4] While Trust Issued Receipts ("TIRs") and Linked Securities ("LSs") can be listed through the MQP, the Exchange believes that the products listed pursuant to the MQP will be predominantly, if not exclusively, ETFs. As such, in this letter the Exchange will focus its comments on ETSs. Moreover, as the Exchange noted in its proposal, ETFs have a multi-layered structure that makes it virtually impossible for a market maker to manipulate the price (NAV) of an ETF product in the MQP; we believe this makes ETFs particularly good candidates for the initial MQP pilot. Filing, p. 7 of 17.

[5] Filing, p 3 of 17.

[6] Traders Magazine Online News, June 27, 2012 (The McHenry bill "mirrors recent proposals by exchanges operated by Nasdaq OMX Group and NYSE Euronext").

Government-Sponsored Enterprises ("market structure hearing") that was held on June 20, 2012,[7] the Chairman of the market structure hearing, Scott Garrett (R-NJ), specifically noted legislative market structure proposals: "Two proposals, Mr. McHenry's draft legislation to implement a Market Quality Incentive Program and Mr. Schweikert's proposal to allow for increased tick sizes for smaller companies, could be ways to provide much needed support to small businesses. While I believe Reg-NMS has achieved many benefits for large cap stocks, I am not certain that the current one-size-fits-all approach is best suited for all public issuers."[8] Mr. McHenry states about his proposed market quality incentive bill: "My thought process here is to incent small companies to seek our exchanges, to seek the public markets. So the idea is that you have some liquidity support."[9] One of the witnesses at the market structure hearing, Thomas M. Joyce of Knight Capital Group, Inc. ("Knight"), testified that Knight fully supports the McHenry legislative proposal; and noted that NASDAQ has a similar market quality proposal, referring to the MQP.[10] Mr. Joyce testified: "As a leading market maker of U.S. equities, Knight supports initiatives designed to improve the liquidity and transparency of the equities markets. We believe that the McHenry and Nasdaq proposals will benefit all market participants including, issuers, investors (institutional and retail), liquidity providers, and the overall U.S. economy by encouraging smaller companies to go public."[11]

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[7] The June 20, 2012, hearing session was the first of several anticipated sessions of the market structure hearing.

[8] http://garrett.house.gov/press-release/garrett-chairs-subcommittee-hearing-examine-us-equity-markets.

[9] Traders Magazine Online News, June 27, 2012.

[10] Knight submitted a letter to the Commission in support of the MQP. Letter from Leonard J. Amoruso, General Counsel, Knight Capital Group, Inc., dated May 4, 2012.

[11] Testimony of Thomas M. Joyce, Chairman and Chief Executive Officer, Knight Capital Group, Inc., Submitted before The Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises Hearing on Market Structure, dated June 20, 2012.

Most Comment Letters Recommend Approval of the MQP

The Commission received a total of eighteen comment letters in response to publication of the Notice, as extended.[12] Ten of the commenters support the Filing. These commenters believe that the MQP will be beneficial and urge the Commission to approve the Filing so that the MQP may go forward. These letters in support of the Filing are penned by four academicians that have personally authored research papers regarding international and European programs similar to MQP ("Market Incentive programs"),[13] or have surveyed the scholarly literature regarding these Market Incentive programs: Professor Daniel G. Weaver,[14] Professor Amber Anand,[15] Professor Albert J. Menkveld,[16] and Professor James J. Angel.[17] The letters in support of the Filing also include: industry groups such as the Investment Company Institute ("ICI"),[18]

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[12] The Commission extended until July 11, 2012, the time within which it may approve or disapprove the proposed rule change or institute proceedings to determine whether the proposed rule change should be disapproved. Securities Exchange Act Release No. 67022 (May 18, 2012), 77 FR 31050 (May 24, 2012)(the "extended period").

[13] See Paying for Market Quality, Working Paper F-2006-06 by Amber Anand, Carsten Tanggaard, and Daniel G. Weaver, November 2005, Aarhus School of Business; and How Do Designated Market Makers Create Value for Small-Caps? by Albert J. Menkveld and Ting Wang, August 1, 2011. See also Why do Firms Pay for Market Making in Their Own Stock? by Johannes A. Skjeltorp, Norges Bank, and Bernt Arne Odegaard, University of Stavanger and Norges Bank, June 2011; Why Designate Market Makers? Affirmative Obligations and Market Quality by Hendrik Bessembinder, Jia Hao, and Michael Lemmon, June 2011; and Designated Sponsors and Bid-Ask Spreads on Xetra by Jördis Hengelbrock, October 31, 2008. These academic works were cited in the MQP proposal. Filing, pp. 4-6.

[14] Letter from Daniel G. Weaver, Ph.D., Professor of Finance, Rutgers Business School, dated April 26, 2012.

[15] Letter from Amber Anand, Associate Professor of Finance, Syracuse University, dated April 29, 2012.

[16] Letter from Albert J. Menkveld, Associate Professor of Finance, VU University Amsterdam, dated May 2, 2012.

[17] Letter from James J. Angel, Ph.D., CFA, Associate Professor of Finance, Georgetown University, dated May 2, 2012.

[18] Letter from Ari Burstein, Senior Counsel, Investment Company Institute, dated May 3, 2012. The ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of $13.4 billion and serve more than 90 million shareholders.

TechNet,[19] and Managed Funds Association ("MFA");[20] a major liquidity center, Knight;[21] a published ETF industry author, Gary L. Gastineau;[22] and an anonymous email submission.[23]

The Commission requested commenters to respond to twenty-three questions.[24] Three commenters that support the MQP responded to the Commission's questions. One commenter responded to all of the Commission's questions;[25] and two commenters responded to some of the questions.[26] One commenter that expressly neither supported nor opposed the MQP, and one commenter that supported the MQP, felt that a longer comment period was warranted.[27]

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[19] Letter from Rey Ramsey, President and CEO, TechNet, dated June 20, 2012.

[20] Letter from Stuart J. Kaswell, Executive Vice President and Managing Director, General Counsel, Managed Funds Association, dated July 3, 2012. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and all other regions where MFA members are market participants.

[21] Letter from Leonard J. Amoruso, General Counsel, Knight Capital Group, Inc., dated May 4, 2012. Knight Capital Group is a global financial services firm that provides access to the capital markets across multiple asset classes to a broad network of clients, including buy- and sell-side firms and corporate issuers. The firm engages in market making and trading across global equities, fixed income, foreign exchange, options and futures. Knight is the leading source of liquidity in U.S. equities among all securities firms across NYSE- and NASDAQ-listed stocks, ETFs and Over-the-Counter Bulletin Board (OTCBB) securities.

[22] Letter from Gary L. Gastineau, Managing Member, ETF Consultants LLC, dated June 11, 2012. Mr. Gastineau is the author of the ETF Exchange-Traded Funds Manual, 2nd edition (Wiley, 2010).

[23] Anonymous email, Amherst, Massachusetts, dated April 18, 2012.

[24] The Commission's questions may be referenced at: Filing, pp. 14-16 of 17.

[25] Letter from James J. Angel, Ph.D., CFA, Associate Professor of Finance, Georgetown University, dated May 2, 2012.

[26] Letter from Gary L. Gastineau, Managing Member, ETF Consultants LLC, dated June 11, 2012. Letter from Albert J. Menkveld, Associate Professor of Finance, VU University

The comments in support of the MQP proposal are, as a group, written by close observers of, or participants in, the securities industry. These comments reflect an understanding of the present liquidity shortcomings in the U.S. market and NASDAQ's effort to increase liquidity and market quality through the MQP proposal. We believe it is instructive to briefly review these comments.

Professor Daniel Weaver states in his comment letter:[28] "In summary, we should allow U.S. firms to directly pay market makers for improving the quality of the market for the firm's securities. In the instant case, the Commission should allow the enactment of NASDAQ's Market Quality Program." Professor Weaver answers all of the questions posed by the Commission. We highlight several.

In answer or the Commission's question 1 (whether the same arguments and rationale apply to operating companies as ETFs), Professor Weaver states: "There will undoubtedly be an improvement in market quality if market makers are incentivized to do so. I suspect that, as with stocks, the benefits will vary across ETFs." In answer to question 4 (how the rationale in support of trading lesser-known or smaller operating companies translates to the need for similar support of an exchange-traded product that tracks these companies), Professor Weaver states: "Any product or operating company with low liquidity will benefit from incentivized improvements in market quality. The key is whether the cost outweighs the benefit. I cannot think of any unintended consequences. In response to question five (given the arbitrage link between trading exchange-traded products and their underlying holdings, why would lack of liquidity impact the ability of market makers to quote relatively narrow bids and offers), Professor Weaver states, as we have argued: "If there is not enough trading in a product to justify an investment in inventory for the market maker they will set a wide spread." In answer to question 8 (do commenters believe the MQP would or would not raise concerns regarding investor confidence, market integrity, and member standards), Professor Weaver states: "The implementation of paying market makers to improve market quality in other countries probably improved investor confidence as evidenced by the increases in volume and order size observed by researchers. I am not aware of a single instance of purported collusion between issuers and market makers in the

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Amsterdam, dated May 2, 2012. Mr. Gastineau and Professor Menkveld responded to seventeen and seven questions, respectively.

[27] Letter from Gus Sauter, Managing Director and Chief Investment Officer, Vanguard, dated May 3, 2012 (neither supporting nor opposing the MQP); Letter from Ari Burstein, Senior Counsel, Investment Company Institute, dated May 3, 2012 (supporting MQP). Messrs. Sauter and Burstein each submitted one letter.

[28] Letter from Daniel G. Weaver, Ph.D., Professor of Finance, Rutgers Business School, dated April 26, 2012. The quotes of Professor Weaver, as well as the quotes of other commenters set forth herein, are from the respective comment letters that were submitted to the Commission, unless otherwise noted.

ten years since the direct payments have existed outside the US.[29] The payments made to market makers, as proposed in NASDAQ's MQP, are not of sufficient size to provide enough incentive for manipulation. In addition the diligence of FINRA and the SEC in overseeing a fair market will act as a very large deterrent, again given the small payments that will be made. Manipulation will not be an issue."

In addition, in response to question 11 (whether the proposed criteria for issuer and market maker participation are clear, precise, and objective), Professor Weaver states that the standards proposed by the Exchange for the MQP "were sufficient." In response to question 17 (adequacy of the 2 million ADV threshhold for program termination) Professor Weaver states: "This is an arbitrary number that is no better or worse than another other large number. It would be best to wait and see what happens when funds meet the threshold and are released. The number may need to be adjusted, but at this point NASDAQ's guess is no worse than any other." And in response to question 18 (whether one year is a reasonable pilot implementation time), Professor Weaver states: "One year is sufficiently long to get an idea as to how things work out." We agree. During the pilot period we will review the efficacy of the MQP and will send metrics to the Commission regarding the MQP.[30] We believe that, based on NASDAQ's experience with the First North Market Incentive program, during the MQP pilot spreads of products in the MQP should significantly narrow, to the benefit of investor and other Program participants.[31]

Professor Weaver notes also that studies of global market quality incentive programs, which we have cited in our proposal and commenters have cited in their letters, have not only found enhanced liquidity but also the following positive attributes: lower transaction costs, improved price discovery, increased volume, lower volatility, lower cost of capital, and increased issuing firm value. We believe that these positive attributes will be seen in the MQP. Finally, Professor Weaver questions whether a ticker symbol identifier would be helpful. The Exchange believes that changing the ticker symbol of a product in the MQP is neither necessary nor desirable. The MQP is designed to be very transparent. The Exchange will clearly note on its public website the names of each product that has been accepted into the MQP, as well as the market makers in such product. Anyone that wants such information can, and will, be able to

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[29] The Exchange stated in its proposal that NASDAQ's First North market has been operating since 2002 without any material regulatory issues. Filing, p 5 of 17.

[30] Filing, p. 12 of 17. The data that will be provided to the Commission during the MQP pilot includes: Rule 605 metrics; volume metrics; number of MQP Market Makers in MQP securities; spread size; and availability of shares at the NBBO.

[31] Filing, pp. 5-6 of 17. The spreads on securities employing market incentives on NASDAQ's First North market were three times narrower the majority of the time, and exhibited less volatile behavior during sever market disturbances.

access it.[32] Thus, because of the information that will be readily available to anyone that wants it, the Exchange believes it is not necessary to brand MQP products through symbology, and believes that this would not benefit the goal of increasing liquidity.

Professor Anand, like Professor Weaver, in his comment letter reviews various studies regarding global market making incentive programs, including the study of the Stockholm Stock Exchange (currently named NASDAQ OMX Stockholm) that he co-authored with Professor Weaver.[33] Professor Anand notes that among the many benefits that market incentive programs provide, "quoted spreads narrow and intraday volatility decline," and there is "improved volatility and reduced cost of capital for contracting firms.[34] Professor Anand states: "The combined evidence from other markets indicates that a paid market making program offers significant promise for improving the liquidity of the stocks of smaller firms. The results of the pilot program proposed by NASDAQ should provide additional guidance in implementing such a mechanism for a larger set of illiquid securities in the US markets."

Professor Menkveld likewise notes in his comment letter[35] that he reviewed the studies regarding global market making incentive programs. Professor Menkveld notes that "the securities the NASDAQ proposed for the MQP program launch (exchange-traded derivative securities products) are less likely to be affected by such insider information risk as ETFs are baskets of securities and security-specific information is therefore less relevant." In response to

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[32] Moreover, the Exchange's website will include additional MQP data, such as: whether in addition to a basic fee a sponsor elects to pay a supplemental fee; and how a sponsor chooses to allocate the supplemental fee between 0% and 100% toward market maker credit for quotes as opposed to credit for trades. Filing, pp. 8, 11 of 17.

[33] Letter from Amber Anand, Associate Professor of Finance, Syracuse University, dated April 29, 2012. Paying for Market Quality, Working Paper F-2006-06 by Amber Anand, Carsten Tanggaard, and Daniel G. Weaver, November 2005, Aarhus School of Business. The Market Incentive program on NASDAQ OMX Stockholm is similar to that on NASDAQ's First North market. We feel that the proposed MQP provides significant and helpful enhancements. In particular, the MQP does not permit financial contact between an issuer of ETF sponsor and a market maker, but rather puts the Exchange squarely between sponsors and market makers in terms of fee collection (from sponsors) and credit allocation (to market makers); and entails a wholly rules-based program that includes specific MQP listing and fee requirements on the one hand and clear liquidity standards for market makers on the other hand.

[34] The Exchange notes, as discussed in the Filing, that the proposed MQP does not entail contracts between issuers and market makers, but rather entails a wholly rules-based MQP process that includes listing and fee requirements for ETF sponsors as well as clear liquidity standards for market makers.

[35] Letter from Albert J. Menkveld, Associate Professor of Finance, VU University Amsterdam, dated May 2, 2012.

the Commission's question 3 (does being a component of an ETF benefit an operating company), Professor Menkveld states: "I do agree with NASDAQ's assertion that membership of an index enlarges the 'visibility' of a company." In response to the Commission's question 6 (would the MQP encourage tighter quote prices and greater quoted size at the NBBO), Mr. Menkveld states: "Yes, I agree that MQP securities' liquidity is likely to benefit." And, Professor Menkveld believes that a one-year period is reasonable for the first introduction of the MQP. The Exchange believes that Professor Menkveld's query regarding a possibly staggered introduction of MQP securities (both in terms of announcement and implementation) and a randomized sequence would add un-needed complexity to the program, and is not necessary in light of the optional nature of the MQP. We do not anticipate that all eligible products will instantaneously migrate to the MQP. Professor Menkveld also queries whether there should be a three month pre-event period to gather data before a security is listed pursuant to the MQP. We believe that any pre-event period is antithetical to the goal of the program to enhance liquidity of products as soon as possible.

Professor Menkveld summarizes: "I am supportive of an MQP pilot study."

Professor Angel expresses in his comment letter[36] his belief that the U.S. is "facing a crisis in our public capital markets...[W]e now have a 'one size fits all' market that does a great job of trading large cap stocks like Intel and IBM. However, smaller companies have trouble attracting attention in the crowded marketplace." Professor Angel expresses his view that in passing the JOBS Act,[37] Congress is sending a message that market structure must be improved for small companies and is urging the Commission to be open to different ways of doing things.[38] Professor Angel urges the Commission to permit NASDAQ and other exchanges "to engage in market structure experiments that may help the market." As we have noted, the MQP proposal is a viable solution to the recognized liquidity problem in the current market structure. In the MQP we are proposing a transparent, rules-based, competitive program with objective, clear and meaningful liquidity (market quality) standards that market makers must meet to receive liquidity incentive credits.

Professor Angel urges approval of the MQP, stating: "I concur with the recommendations that Professors Anand and Weaver make in their eloquent comment letters. Other countries

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[36] Letter from James J. Angel, Ph.D., CFA, Associate Professor of Finance, Georgetown University, dated May 2, 2012.

[37] The JOBS Act calls for relaxation of some of certain regulatory requirements on smaller public companies, and also calls for studies on market-structure issues such as, for example, tick size.

[38] Professor Angel argues that if the Commission does not get Congress's message then it is likely that Congress will step in and pass legislation to fix the public capital markets (such as the JOBS Act or the previously-noted Mc-Henry bill).

permit issuers to compensate liquidity providers without problem, so there is no reason that such programs cannot work effectively here. NasdaqOMX has extensive experience operating exchanges in those countries, so they clearly have the relevant expertise to administer such programs in this country in such a manner as to prevent harm to market participants." NASDAQ re-iterates that it ran a Market Incentive program on First North market since 2002. The First North program has been successful on many levels. The First North Market Incentive program has enhanced liquidity and market quality for all participants, including issuers and investors. The program has significantly reduced spreads and overall transaction costs. And finally, under NASDAQ's guidance the First North program has done so without any known regulatory problems.[39]

Professor Angel believes that "NASDAQ, like all exchanges, should have the commercial flexibility to experiment with different market structures...Permitting issuers of all securities, not just ETFs, to compensate market makers would be a good idea." Professor Angel states that an alternate way to compensate market makers may be to permit issuers to levy a 12b-1 style marketing fee on each trade (collected like the section 31 fees) that could be used to pay for market making and independent research." We believe that while Professor Angel may see 12b-1 fees as an alternative compensation structure to incent market makers, Professor Angel is in agreement with the Exchange that in terms of the MQP, 12b-1 fees do not need to be applied. We discuss this below.

Ari Burnstein, on behalf of ICI,[40] states: "As ETF sponsors, ICI members have a strong interest in ensuring that the securities markets are highly competitive, transparent and efficient, and that the regulatory structure that governs the markets encourages liquidity, transparency, and price discovery." With this, the ICI fully supports the MQP: "Consistent with these goals, ICI supports the overall goal of the MQP - to incentivize market makers to make high-quality, liquid markets in ETFs. To the extent the MQP results in narrower spreads and more liquid markets for ETFs, without any associated unintended consequences for ETFs or the markets as a whole, the MQP could prove beneficial. Similarly, increased competition among market makers should be encouraged and could result in better quotes by market makers for ETFs. As the Release notes, liquid markets are critical for ETFs, particularly smaller and less frequently traded ETFs."

Recognizing the current prohibition against paid for market making in the U.S., ICI states: "We appreciate that these [MQP] rules were put in place to address concerns surrounding the payment of incentives to market makers, *i.e.*, concerns regarding investor confidence and market integrity, and whether such payments raise conflicts of interest between an issuer and the market maker for a security." "ICI supports efforts by NASDAQ to address concerns about investor confidence and market integrity that are associated with the MQP through, among other things, disclosure requirements and overall transparency built into the program."

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[39] Filing, pp. 5-6 of 17.

[40] Letter from Ari Burstein, Senior Counsel, Investment Company Institute, dated May 3, 2012.

ICI notes also that it particularly supports provisions in the proposal that will require NASDAQ to provide information to the SEC during the pilot about market quality such as "volume metrics, number of MQP market makers in ETFs, and spread size." Noting that the MQP release does not discuss availability of data gathered under the pilot program for ETF sponsors, the ICI encourages that data be made available to sponsors. The Exchange notes that it intends to give sponsors access to trading data associated with liquidity provision in their products such as, for example, the performance of market makers for such products. We believe it is prudent to provide data to the sponsor community that is utilizing the MQP and funding the Program.

Leonard Amoruso, the author of the Knight letter,[41] states that Knight fully supports the MQP and looks forward to participating in the program. Knight states: "We expect that the pilot will yield useful evidence to gauge the effectiveness of the program. If successfully implemented by NASDAQ, we believe that the MQP will not only aid liquidity creation in less active securities, but may well incentivize other market participants to make markets in securities in which they would not normally trade – thereby creating a more robust marketplace for these issuers." Knight indicates that a correct threshold for discontinuance of the program may require additional study. Our response is noted below.

Gary Gastineau states in his comment letter[42] that the MQP proposal 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. 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." Mr. Gastineau goes on to explain that he is "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." In answer to Mr. Gastoneau's query regarding who will pay for the MQP, we note that it will be ETF sponsors.

While Mr. Gastineau responded to many questions posted by the Commission in the Filing, and Mr. Gastineau's responses were favorable, similarly to the responses of the other commenters that answered Commission questions, for brevity we will only note a few. In answer to the Commission's question 5 (given the arbitrage link between trading exchange-

[41] Letter from Leonard J. Amoruso, General Counsel, Knight Capital Group, Inc., dated May 4, 2012.

[42] Letter from Gary L. Gastineau, Managing Member, ETF Consultants LLC, dated June 11, 2012.

traded products and their underlying holdings, why would lack of liquidity impact the ability of market makers to quote relatively narrow bids and offers), Mr. Gastineau states: "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." As we discuss below, we believe that arbitrage opportunities are an inherent part of the securities industry (including ETFs) that may enable market makers to more efficiently manage their risk. In response to the Commission's question 6 (would the MQP encourage tighter quote prices and greater quoted size at the NBBO), Mr. Gastineau states: "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"." In response to the Commission's question 19 (would it be helpful to require companies to be listed and traded outside the MQP for a period of time before being eligible for MQP, Mr. Gastineau states: "A period after an ETF launch without participation in MQP would be an unnecessary and inappropriate handicap for new ETFs." We believe, as noted, that any such mandatory period would go against the goal of the Program – to enhance liquidity for products – and could have negative results for ETFs that need liquidity.

TechNet recognizes the need for the MQP and urges that it be approved in its comment letter:[43] "TechNet hopes the SEC will look favorably on NASDAQ's MQP and allow this innovative experiment in market structure to go forward." TechNet clearly recognizes the immediate goal of the MQP as well as its prospective benefit: "The Market Quality [Program] is designed to encourage liquidity where it generally has not flourished, and would make securities that elect to participate in the program more attractive to a broader range of investors. Looking forward, the MQP could benefit promising tech companies that today may lack liquid, quality markets. Improving the U.S. capital markets will help foster high-growth companies that are essential to our nation's long-term competitiveness in the global economy."

Managed Fund Association in its comment letter[44] clearly recognizes the liquidity problem in our markets: "The markets for small-cap securities...are often faced with limited liquidity and limited trading volumes; which make such securities more risky and difficult to trade for investors. We applaud NASDAQ in its efforts to develop innovative solutions to enhance market quality and liquidity for small-cap securities." MFA specifically notes the positive market maker incentive experience on a global level, stating: "We believe the experience of the Scandinavian and European exchanges, and the findings of the academic studies on payment for market making programs are promising and lend support for the trial of

[43] Letter from Rey Ramsey, President and CEO, TechNet, dated June 20, 2012.

[44] Letter from Stuart J. Kaswell, Executive Vice President and Managing Director, General Counsel, Managed Funds Association, dated July 3, 2012.

such a program in the United States." MFA concludes: "Accordingly, we are interested in the adoption of the MQP for certain listed-securities on a pilot program."[45]

Finally, we note an anonymous comment letter[46] that urges the Commission to allow the MQP to go forward. The commenter notes that "it seems reasonable for the Security and Exchange Commission to administer a program which would cause market makers to be more responsible in their day (sic) trading." Referring to the proposed MQP, the commenter notes that having a structure of rules " would provide greater liquidity and create a better quality of market organization, [and having] the NASDAQ work in between the funding delivered by the issuer to the market maker will ensure the professional integrity of the program, and the responsibility of the market maker."

Some Comment Letters Oppose Approval of the MQP

Several comments in opposition to the MQP were submitted to the Commission during the initial part of the comment period. These comments were, unlike the nine letters urging approval discussed above, which are each several pages long, all submitted in the form of short, conclusory emails ("email comments").[47]

We first discuss the email responses, followed by the Modern Networks IR letter.[48]

One email commenter, Jeremiah O'Connor III,[49] states: "Please stop cow towing to high frequency trading. They are extremely detrimental to long term stability of all U.S. markets. How many more flash crashes can our financial system endure?" Mr. O'Connor clearly does not understand the MQP proposal. The MQP has nothing to do with high frequency trading (HFT). Whatever one's opinion of HFT, by definition it requires securities volume and liquidity. The type of products that we expect will be in the MQP (predominantly low-volume ETFs that do not have adequate liquidity) certainly do not fit this requirement; nor will the MQP, in our opinion,

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[45] MFA supports limiting the scope of the MQP to ETFs, LSs and TIRs, as the Exchange has proposed in the MQP proposal pending before the Commission.

[46] Anonymous email, Amherst, Massachusetts, dated April 18, 2012.

[47] Email from Frank Choi, dated April 13, 2012; Letter from Christopher J. Csicsko, dated April 14, 2012; Letter from Jeremiah O'Connor III, dated April 14, 2012; Letter from Dezso J. Szalay, dated April 15, 2012; Letter from Kathryn Keita, dated April 18, 2012; Letter from Mark Connell, dated April 19, 2012.

[48] Letter from Timothy Quast, Managing Director, Modern Networks IR LLC, dated April 26, 2012.

[49] Email from Jeremiah O'Connor III, dated April 14, 2012.

make these products attractive to HFT. Moreover, as we have noted, once a product in the MQP reaches a sustained liquidity level of 2 million ADV over three consecutive months, it will not be eligible to be in the Program.

Another email commenter, Frank Choi,[50] states that the MQP should not be allowed because: "the market becomes ever more distorted and tilted to those who create an unfair marketplace." To the contrary, we believe that by creating liquidity and market quality, the MQP will serve to open the market to more participants. The MQP will be a win for all: for the ETF sponsor or company that lists a liquidity-challenged product with the MQP and experiences added liquidity; for the market maker that receives a modest credit for "stepping up to the plate" and is willing to take on added risk by enhancing liquidity pursuant to MQP standards; and for the investor that experiences liquidity on both sides of the trading continuum (bid and ask) at lower transaction cost.[51] This will occur, we believe, because the competitive, and transparent, nature of the MQP will attract liquidity providers in ETFs and other securities.

Yet another commenter, Kathryn Keita,[52] claims that the MQP will make it harder to understand and regulate markets.[53] We disagree. The MQP is transparent and, we believe, very understandable with clear standards specified for all participants in the Program. We note further that substantial information will be provided on the Exchange's website about significant aspects of the MQP such as: who and what products are in the Program; the market makers in each product; and any supplemental fees paid for these products. Moreover, MQP securities will be traded on a highly regulated and transparent exchange (NASDAQ), pursuant to the current trading and reporting rules of the Exchange, and pursuant to the established market surveillance and oversight procedures of the Exchange.

Finally, two email commenters, Christopher Csicsko and Mark Connell,[54] state that they oppose the MQP because it is contrary to 1997 regulations that prohibit payment to market makers and would undo protections for markets and investors. The primary goal of the so-called 1997 regulations, we believe, is to prohibit market makers from getting paid by issuers for

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[50] Email from Frank Choi, dated April 13, 2012.

[51] We note that lower transaction cost is as beneficial to an ETF sponsor or listing company as it is to an investor.

[52] Email from Kathryn Keita, dated April 18, 2012.

[53] Ms. Keita also states that the proposal "is to support nothing more than statistical arbitrage." Our comments regarding statistic arbitrage can be read in respect of Messrs. Quast and Gastineau, and are not repeated here.

[54] Email from Christopher J. Csicsko, dated April 14, 2012; Email from Jeremiah O'Connor III, dated April 14, 2012.

increasing volume without truly supporting liquidity and quality markets, such as the "pump and dump" schemes that were, unfortunately, prevalent years ago. We do not believe that the MQP will promote such negative behavior. We note, in particular, that in terms of flow of funds the MQP is designed so that the Exchange stands between a sponsor or company that lists a product pursuant to the MQP and an MQP market maker of that product. An MQP sponsor or company cannot and does not, under any circumstances, pay any funds to an MQP market maker. The MQP is constructed so that the exclusive method by which an MQP market maker can earn an MQP credit is to maintain a quality market in terms of the spread and liquidity of an MQP product. The credit is administered by the Exchange, and the Exchange will not pass the credit to a market maker if the market maker does not meet the MQP liquidity standards.[55] The Program does not afford any other way for an MQP Market Maker to earn an MQP Credit. The Exchange firmly believes that the lack of sponsor/market maker financial contact, in addition to the clear, unambiguous, and transparent nature of the Program and its established market quality standards, are counter - indicative of promoting or enabling the pump-and-dump type of behavior targeted by the 1997 regulations. Additionally, we note that the products that we believe is most likely to participate in the MQP, ETFs, have a structure that inherently protects against, and effectively eliminates, the opportunity for price manipulation by a market maker. The performance of the underlying index or basket of securities is the determinant and driver of a ETF's value and therefore its market price. Thus, if a market maker were interested in improperly manipulating the price of an ETF, he would first have to manipulate the price of the underlying index or basket of securities, which is impracticable because of the multi-layered structure of the ETF; and then he would have to accept the risk of movement in the price of the overall market as well as the price of the underlying components.[56]

The final comment letter opposing approval of the MQP, signed by Mr. Timothy Quast on behalf of Modern IR, raises two objections to the MQP proposal.[57] First, Mr. Quast argues that the statutory basis offered by the Exchange does not comport with the MQP program's

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[55] The market making standards proposed in the MQP are unique and will, undoubtedly, promote the enhancement of liquidity:
(i) For at least 25% of the time when quotes can be entered in the Regular Market Session as averaged over the course of a month: at least 500 shares quotes or orders at the NBBO or better *on the bid side*, and at least 500 at the NBBO or better *on the offer side* of an MQP Security; and
(ii) For at least 90% of the time when quotes can be entered in the Regular Market Session as averaged over the course of a month: at least 2,500 shares of attributable, displayed posted liquidity on the Nasdaq Market Center that are priced no wider than 2% away from the NBBO *on the bid side*, and at least 2,500 shares *on the offer side* of an MQP Security. Filing, P11 of 17 and proposed Rule 5959(c)(i)(B).

[56] See also Filing, p. 7 of 17.

[57] Letter from Timothy Quast, Managing Director, Modern Networks IR LLC, dated April 26, 2012.

objective. And second, Mr. Quast argues that the MQP will increase statistical arbitrage, which according to Mr. Quast is not investment activity or capital-formation but speculative, short-term trading. We will address these seriatim.

Regarding statutory basis, Modern IR indicates that the Exchange provides one paragraph statutory basis.[58] Nothing could be further than the truth. In the proposal, the Exchange submitted a pages-long statutory basis for the MQP. The Exchange believes that the statutory basis clearly supports the MQP proposal. The Exchange notes, in its statutory basis statement, that the goal of the MQP in the statutory basis - to incentivize members to make high-quality, liquid markets - supports the primary goal of the Act to promote the development of a resilient and efficient national market system. The Exchange explains how each aspect of the voluntary MQP adheres to and supports the Securities Exchange Act of 1934 ("Act"), and how the MQP represents an equitable allocation of fees and dues among Market Makers. Competitive Market Makers that choose to undertake increased burdens pursuant to the MQP will be rewarded on a pro rata basis with increased credits while those that do not undertake such burdens will receive no added benefit. Any portion of an MQP Fee that is not credited to eligible MQP Market Makers will be refunded to the relevant MQP Company. That is, all of the benefits of the MQP Fees will flow to high-performing Market Makers rather than to NASDAQ, provided that at least one Market Maker fulfills the obligations under the proposed rule. And additionally, the Exchange indicates that the MQP is designed to avoid unfair discrimination among Market Makers and issuers by containing objective, measurable (universal) standards that NASDAQ will apply with care both for issuers and for Market Makers and will be applied equally to ensure that similarly situated parties are treated similarly.[59]

Mr. Quast's claim that the MQP will, by design, increase statistical arbitrage by spreading it "further down market strata to help [NASDAQ's] best customers while generating profits for itself," does not have merit. As we have amply demonstrated in our proposal, and noted in this letter, the MQP is designed to increase liquidity and market quality of listed products including ETFs through clear, rule-based liquidity standards. Despite Mr. Quast's diatribe about the evils of statistical arbitrage, we believe that arbitrage is, and will remain, a part of the securities industry. Thus, recognizing the existence of arbitrage, we believe that first, the MQP is not designed to inherently increase statistical arbitrage, and second that arbitrage will

[58] The alleged one paragraph statutory basis, according to Mr. Quast, is: 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) (15 U.S.C. 78f) and 6(b)(5), in particular (15 U.S.C. of the Act78f(b)(4) and (5)), 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.

[59] Filing, pp 12-13.

remain irrespective of our MQP proposal.[60] Finally, we note that arbitrage may, in fact, serve to help align the pricing of ETFs in that the arbitrage complex that exists within the creation/redemption process allows investors to experience a tighter execution as it relates to the fund's asset value.

We note that at the core of Mr. Quast's Modern IR letter is a fundamental skepticism about ETFs, and opposition to them as viable financial instruments. Mr. Quast's comment letter reads like a diatribe about all things ETF. Mr. Quast's clear anti-ETF bias is demonstrated by his statement that "It's a wonder that ETFs are legal." Mr. Quant states that as the number of companies declined in the National Market System, the ETF "cabal" is seeking to protect its own interests - arguably through the MQP. Mr Quast even goes so far as to say that because the Commission is reliant on Section 31 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."

In spite of Mr. Quast's obvious bias against ETFs, in the last decade ETFs have enjoyed unprecedented expansion while equity investing has declined; it is safe to say that ETFs have become one of the most popular investing vehicles available to, and used by, investors. At the same time, as we have noted in our proposal, there is a liquidity crisis for ETFs and other exchange-listed products.[61] The MQP provides an excellent solution.[62]

<u>Vanguard Neither Supports nor Opposes the MQP</u>

The Vanguard letter (which neither supports nor opposes MQP) acknowledges the extensive safeguards that the Exchange has built into the MQP in an effort to address the concerns that underlie the prohibition on issuer payments to market makers. Vanguard believes these safeguards are important and applauds NASDAQ for including them in the proposed

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[60] We note that although Mr. Gastineau also discussed arbitrage in his comment letter, unlike Mr. Quast, Mr. Gastineau does not see arbitrage as a negative penomenon vis a vis the MQP, but rather sees it as a functional process.

[61] There are about 300 funds (well over 200 of them being ETFs) on the current "ETF Deathwatch" list maintained by Ron Rowland, president of Capital Cities Asset Management. All the funds on this list have limped along for at least three months with less than $ 5 million in assets or fewer than $ 100,000 worth of shares changing hands daily. The list now includes about 17% of the industry's approximately 1,400 ETFs and exchange-traded notes, as measured by number of funds.

[62] Finally, we note that Mr. Quast claims that "...a requirement that rules promote just and equitable principles of trade [means that] EVERYTHING AND EVERYONE IS TREATED THE SAME WAY." On the most fundamental level, Mr. Quast's argument would not allow any exchange to differentiate for any reason. Clearly, this is not the intent or requirement of the Act.

Program. Mr. Sauter states in the letter: "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 ETFs 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 [be eligible to] receive Program payments; and opportunity for multiple market makers to compete for payments on each participating ETF." Mr Sauter states further: "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."[63]

Vanguard lists six "areas of concern" regarding the MQP. First, Vanguard asks what effect the Program may have on ETFs that do not to participate in the Program, potentially rendering nonparticipating ETFs as "orphan" funds with diminished market making activity. The Exchange does not envision that products that do not participate in the program will become "orphaned." Whether or not a fund is in the MQP will be wholly up to the sponsor of the fund. We do not believe that market makers will be able to "orphan" any fund by diminished market making activity, based on the MQP as proposed. Instead, we anticipate seeing increased liquidity and market quality in those funds that do participate in the Program, and anticipate that the liquidity characteristics of those funds that ETF sponsors decide not to participate in the Program will largely remain unchanged (e.g. they will continue to be less than adequate). While the economics of the MQP should work to incentivize market makers to take on additional risk and make deeper and more liquid markets in MQP securities, the MQP will not cause a diminution of market quality for ETFs that are not a part of the Program. The Exchange believes that the emphasis should, and indeed must be, on the potential liquidity that will be gained for MQP products for all participants including investors – at reduced transaction costs.

Next, Vanguard asks whether competitive forces will effectively render the voluntary MQP program into a compulsory, "pay to play" environment. We believe not. We have taken great strides to make the MQP wholly voluntary, and are confident that the Program will remain voluntary. We do not envision that the modest market maker credit proposed in the MQP for taking on additional risk and making more liquid markets will transform the culture of the current ETF landscape into a "pay to play" situation. We do envision, however, that the net benefit of participation in the Program should outweigh the associated fee for ETF sponsors, and the associated additional risks and liquidity responsibilities for market makers, to make the MQP an attractive option. We note that the MQP was designed as a competitive program for a competitive marketplace; and as such will increase liquidity at lower cost to all participants. We are confident that the MQP will add an element of competition that is healthy and beneficial to the liquidity paradigm of ETFs (and any other MQP securities) and will serve to broaden the spectrum of firms engaged in liquidity provision within the marketplace.

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[63] Mr. Sauter questions whether these safeguards will be sufficient. As we have demonstrated in the letter and the proposal, and as numerous comments have opined, the safeguards built into the MQP are more than sufficient to allow the proposal to go forward on a pilot basis.

Vanguard also asks whether a lower trading volume threshold is more consistent with the stated goals of the Program as well as the public interest (whether another metric should be used), and whether the Program should be restricted to newly created ETFs. We believe that using a Program discontinuance metric based on average daily volume (ADV) over a three month period is the proper discontinuance metric. The MQP is not for ETFs such as SPY or QQQ that have self sustaining, deep pools of liquidity, but instead is designed for less liquid products. The MQP is proposed on a pilot basis. During the pilot period, the Exchange will submit data to the Commission and will evaluate the efficacy of the program; as with any pilot program, the Exchange will make adjustments to the program as needed. Moreover, the voluntary nature of the program gives each ETF sponsor the ability to make liquidity determinations based upon their experience and satisfaction with the level of liquidity present in the quoting and trading of a product in the Program. Furthermore, we do not believe that it would be proper to restrict the MQP to new ETFs only. As we have noted in the proposal and in this letter, numerous products currently exist (e.g. about 300 exchange traded products, most of them ETFs, on a "death watch") that may benefit from liquidity enhancement.

Vanguard asks whether the public interest be better served if there was a time limit on an ETF's participation in the Program. We do not think so. Rather, we believe, as discussed above, that an ETF (or other product) in the Program should be terminated once it has achieved sustained liquidity - evidenced by reaching and sustaining a volume threshold. We believe that the participation in the Program is at the discretion and option of an ETF sponsor and should not be limited by the Exchange or the Commission; the commercial viability, and acceptable liquidity, of a product should be the determination of the sponsor.

Vanguard suggests that the Commission consider the MQP and the NYSE Arca proposal[64] together and not in isolation. We believe that the Commission is, indeed, reviewing the two proposals simultaneously. We note that the MQP provides the following unique elements: a competitive program that is open to all Exchange market makers; specific liquidity standards for market makers to earn a credit; a transparent, rules based Program that will provide extensive Program information on the Exchange's web site; and the Exchange standing between every ETF sponsor and MQP market maker in terms of the flow of funds. We note also that the MQP is unique in that it is clearly designed for one goal: the enhancement of liquidity and market quality. Thus, the Exchange will credit only those market makers that have sustained a liquid market according to the MQP market quality standards, will return all unused fees to the sponsor, and will not retain any portion of the fee for its own use.

[64] Securities Exchange Act Release No. 66966 (May 11, 2012)(SR-NYSE-Arca-37)(Notice of Filing of Proposed Rule Change Proposing a Pilot Program to Create a Lead Market Maker Issuer Incentive Program for Issuers of Certain Exchange-Traded Products Listed on NYSE Arca, Inc.).

Vanguard suggests that for the avoidance of doubt, NASDAQ to clarify who would pay the Program fees, the issuer of an ETF or the ETF sponsor. As we have noted, Program fees will be paid by ETF sponsors.

Rule 12b-1

The Exchange believes that Rule 12b-1 pursuant to the Securities and Exchange Act is not implicated in respect of the MQP, and the MQP does not require any 12b-1 distribution plan.

Rule 12b-1 makes it unlawful for any registered, open-end management investment company to act as a distributor of securities for which it is the issuer, except through an underwriter or as provided in the rule. For purposes of Rule 12b-1, a company will be acting as a distributor of securities of which it is the issuer, other than through an underwriter, if it engages directly or indirectly in financing any activity which is primarily intended to result in the sale of shares issued by such company.

Rule 12b-1 permits a fund (ETF) to act as a distributor of securities of which it is the issuer and thus pay distribution fees out of fund assets only if the fund has adopted a 12b-1 distribution plan authorizing their payment. In this case even if, arguendo, one were to assume that payment of MQP credits to MQP market makers is primarily intended to result in the sale of shares (which it is not as the clear intent is to establish a quality market for products), the ETFs that would be listed on the Exchange are not making the payments. Rather, as we have discussed, the payments are coming from such ETFs' sponsors. As such, a Rule 12b-1 distribution plan is not required, and in fact is contra-indicted.

Conclusion

Market Incentive programs have been used globally for decades. These programs have been very successful, as noted by several noted academic studies, and have significantly narrowed trading costs while increasing liquidity for all participants. NASDAQ has been successfully administering Market Incentive programs on its First North market in the Nordics, and will do the same with the MQP in the U.S. Recognizing that there is a liquidity crisis in areas of the U.S. markets, the NASDAQ has created the MQP to incentivize market makers to enhance liquidity. The MQP is a competitive, clear, and transparent rules-based program that encourages market makers to enhance liquidity where it is needed. For the sake of market participants, all of whom need and benefit from liquidity, the MQP should be allowed to go forward.

The great majority of commenters recognize the current need for liquidity in the market and recommend approval of the MQP. We urge the Commission to follow these recommendations and approve the MQP proposal as soon as possible.

We appreciate the opportunity to address the Commission regarding the MQP proposal.

Respectfully submitted,

Joan C. Conley

Joan C. Conley

cc: The Hon. Mary L. Schapiro, Chairman
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
The Hon. Daniel M. Gallagher, Commissioner

Robert W. Cook, Director, Division of Trading and Markets
David S. Shillman, Associate Director, Division of Trading and Markets