

April 29, 2012

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

Dear Ms. Murphy,

Thank you for the opportunity to comment on NASDAQ proposal SR-NASDAQ-2012-043. In this letter, my primary focus is on the results of a paper that Carsten Tanggaard, Dan Weaver and I co-authored (hereafter, Anand, Tanggaard and Weaver (2009)), which may be relevant to answering some of the questions regarding the proposal. I will also briefly outline the results of other academic studies which have analyzed similar programs in different markets.

I believe that the issue of enhancing liquidity for small, illiquid securities is important for capital creation and investor participation. Bessembinder, Hao and Lemmon (2011) show that maintaining a level of liquidity provision that is higher than the level that would endogenously arise can increase welfare and enhance efficiency for certain securities. However, maintaining a higher level of liquidity is costly and the market makers designated to supply this additional liquidity need to be compensated.

Several markets in Europe have established programs whereby issuers make an explicit payment to market makers for maintaining a mandated level of liquidity. In Anand, Tanggaard and Weaver (2009), we study one such program on the Stockholm Stock Exchange (SSE). The program on the SSE allows issuers to contract directly with a market maker (the designated market maker, or DMM) for liquidity provision. Subject to a minimum level of liquidity required by the exchange, the issuers are free to negotiate higher levels of liquidity provision. In return, the issuers directly pay a negotiated amount to the DMM. This mechanism allows an issuer to decide whether they would benefit from the presence of a DMM and to choose a desired level of liquidity. Anand, Tanggaard and Weaver (2009) focus on 50 firms which entered into contracts with DMMs between 2002 and 2004. We find that, as expected, firms with relatively illiquid stocks enter into contracts with DMMs. Firms with high levels of liquidity do not contract with DMMs. Interestingly, firms with very low levels of liquidity are also less likely to enter into such contracts, perhaps due to the prohibitively high compensation that DMMs would demand for providing liquidity for such firms. Thus, allowing issuers to decide on their liquidity appropriately allows each issuer to weigh the benefits and costs associated with the presence of DMMs, and we are most likely to see contracts where benefits exceed the costs.

We document significant benefits for the firms which contract with DMMs. Relative to a matched sample, their quoted spreads narrow and intraday volatility declines. The beneficial impact of the presence of a DMM is particularly pronounced on days of higher volatility and lower volume. We find that firms often contract for maximum spread levels that are equal to or higher than their pre-contract average spreads. This indicates that issuers focus on the incidence of wide spreads rather than on average spread levels. As expected, setting a maximum bound on spreads dramatically reduces the observed frequency of spreads wider than the contracted levels. More importantly, spreads decline to a level far below that mandated by the contracts. For example, after contract initiation 70% of the spreads are 50 basis points smaller than the contracted spread and 51% are 100 basis points smaller than the contracted spread. These results potentially indicate a change in the competitive behavior of other limit order traders in the presence of DMMs. If other limit order traders compete more aggressively in the presence of DMMs, the spread can narrow beyond the levels mandated in the DMM contract. Thus, there may be positive externalities associated with DMM contracts. We find that these significant improvements in

market quality are associated with a reduction in the cost of capital for the firms which enter into DMM contracts.

We find that DMMs trade in a manner consistent with their role as liquidity providers. Specifically, DMMs primarily trade passively, and are more likely to trade passively against market movements and at times when spreads are large.

Our study is not alone in documenting benefits of DMMs. Venkataraman and Waisburd (2007), Menkveld and Wang (2011) and Odegaard and Skjeltrop (2011) study the implementation of DMM programs in other European markets and find improved liquidity and reduced cost of capital for contracting firms. Thus, academic empirical evidence is remarkably consistent in support of mechanisms that introduce DMMs to improve liquidity in illiquid stocks.

There is one difference between the context of these studies and the US markets. The studies mentioned above focus on markets which are centralized, with trading concentrated in one market. In contrast, US equity markets are highly fragmented. A fragmented market raises the possibility that order flow will be diverted to DMMs only when liquidity is scarce, which would exacerbate the adverse selection problem faced by DMMs. However, even in such a scenario, the concern would be about the economic viability of the DMM and the amount of compensation necessary to overcome the losses due to higher adverse selection, not about the benefits to markets, investors and issuers. On the other hand, order flow may not be systematically adversely routed, which would avoid the issue altogether.

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.

Thank you again for the opportunity to comment on this proposal.

Sincerely,  
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Encl: references.

References:

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