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Via Electronic Submission

June 7, 2012

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

Re: File Number SR-NYSEArca-2012-37
Release No. 34-66966
NYSE Arca proposal to create an ETP Lead Market Maker Issuer Incentive Program

Dear Ms. Murphy:

Vanguard appreciates the opportunity to provide the Securities and Exchange Commission ("Commission") with our views on NYSE Arca's ("Arca") proposal to create a new Fixed Incentive Program (the "Program") on a pilot basis (the "Proposal").[1] Under the Program, an ETP listed on the Arca Exchange (the "Exchange") would be permitted to pay money to Arca that in turn would be paid to the ETP's lead market maker ("LMM"). As of May 31, 2012, Vanguard was the sponsor of 64 ETFs (48 of which were listed on the Exchange) with collective assets of approximately $197.4 billion ($189.3 billion on the Exchange).

I. Background

Arca's proposed Program is similar to programs previously adopted by the BATS Exchange[2] and previously proposed by Nasdaq[3] in that they all seek to increase compensation to market makers ("MMs"). The BATS and Nasdaq programs provide compensation to MMs for the purpose of promoting better market quality (*i.e.*, narrower spreads and deeper books) for eligible ETPs; compensation is paid to those MMs who make the best markets either on a daily (BATS) or quarterly (Nasdaq) basis. The Arca Program, by contrast, compensates MMs as a means to incent them to serve as LMMs. According to Arca, "market makers may be forgoing

[1] *Self-Regulatory Organizations; NYSE Arca, Inc.; 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.,* Exchange Act Release No. 66966 (May 11, 2012) (the "Proposing Release").

[2] Exchange Act Release No. 66034 (Dec. 22, 2011) (proposing release); Exchange Act Release No. 66307 (Feb. 2, 2012) (adopting release).

[3] Exchange Act Release No. 66765 (April 6, 2012) (proposing release). The SEC has not yet approved or disapproved Nasdaq's proposal. On May 18, 2012, the Commission extended the date by which it will make a decision on the Nasdaq proposal from May 27 to July 7, 2012. Exchange Act Release No. 67022 (May 18, 2012).

LMM assignments in ETPs – instead choosing to trade ETPs as Market Makers or [Equity Trading Permit] Holders – because the incentives to serve as LMM are insufficient to outweigh the obligations, minimum performance standards, and other risks" imposed on or incurred by LMMs.[4] Incenting MMs to serve as LMMs is important, Arca maintains, because of the critical role LMMs play in promoting "a consistent, fair and orderly market in ETPs on the Exchange."[5]

As we noted in our comment letter on the Nasdaq market maker incentive proposal, issuer payments to market makers have been prohibited, for good reason, since at least 1973.[6] We believe that exceptions to that prohibition, such as those proposed by Nasdaq and Arca, should be made only if the rationale is compelling and the exception is narrowly tailored to accomplish an important public policy goal, such as providing demonstrable benefits to long-term investors. For the reasons discussed below, we believe Arca has not met this standard. Many of the concerns we expressed in the earlier comment letter about Nasdaq's proposal apply equally to Arca's Proposal.[7] While we will not here repeat the discussion of those concerns, we think Arca's Proposal raises additional concerns that the Commission should think about as it considers generally whether to permit ETP issuers to pay for market making services and specifically the two pending proposals.

II. Discussion and Analysis

A. <u>The Program does not clearly benefit markets and long-term investors</u>

As noted above, Arca's justification for the Program is that existing revenue sources are insufficient to incent MMs to take on the burdens and risks of being an LMM, and therefore additional sources of revenue are needed. Arca's focus is on the needs of MMs, not investors, and Arca has provided little evidence demonstrating how the Program will benefit investors. Moreover, according to the data provided by Arca in support of its Proposal, under the existing, ostensibly insufficient, compensation arrangements, more than 90% of ETPs manage to attract and retain LMMs.[8] In our view, this data point does not provide a compelling rationale for rolling back a long-standing investor protection principle.

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[4] Proposing Release, at 5-6.

[5] *Id*. at 5.

[6] Vanguard's comment letter on the Nasdaq market maker incentive program contains a more detailed discussion of the history of the rule prohibiting issuer payments to market makers. *See* www.sec.gov/comments/sr-nasdaq-2012-043/nasdaq2012043-13.pdf.

[7] *Id.* For example, both proposals (i) raise concerns that issuer payments to MMs have the potential to distort market forces; (ii) fail to place a time limit on an ETP's participation in the program; (iii) could lead to diminished market making activity in ETPs that are ineligible to, or choose not to, participate in the program; and (iv) could create a pay-to-play environment, effectively forcing issuers to pay up to maintain quality markets for their eligible ETPs.

[8] Proposing Release, at 6.

Even if incenting MMs to serve as LMMs (as opposed to benefiting investors) were a sufficient objective, Arca's program is not narrowly tailored to achieve that objective. To the extent existing incentives are insufficient, it is because those incentives are linked to the number of trades an LMM executes – and trading volume for many ETPs is quite low. However, as the Program is proposed, nothing prevents an ETP issuer from enrolling in the Program an ETP that already has ample trading volume and therefore robust MM activity and good market quality. To address this issue, we believe the Program should include objective eligibility criteria tied to trading volume and/or market quality.[9] Such criteria would ensure that issuer payments to MMs are permitted only in situations where existing compensation arrangements are demonstrably insufficient to incent MMs to serve as LMMs.

In addition, to ensure that the Program benefits investors, the Program should impose materially higher minimum performance standards on LMMs. Currently, Arca LMMs are subject to certain minimum performance standards, the levels of which are determined from time to time by Arca.[10] To receive payments under Arca's LMM incentive Program, an LMM need only meet these minimum standards. The Program is not competitive because all the money contributed by a participating ETP issuer goes to its designated LMM so long as that LMM meets the minimum standards.

In this regard, Arca's program is different from the BATS program currently in place and the proposed Nasdaq program, each of which pays money only to the MMs that make the highest quality markets. Although one can take issue with aspects of the BATS and Nasdaq programs, both are intended to increase market quality, which directly benefits investors purchasing and selling shares of participating ETPs. By contrast, investors purchasing and selling shares of ETPs participating in the Arca Program will not benefit from the Program unless (a) the ETP issuer, independent of the Program, requires the LMM to meet enhanced performance standards, or (b) the LMM maintains a higher quality market than would exist in the absence of the Program. Arca has not demonstrated that either of these outcomes will consistently occur.

We believe the Commission should not approve the Proposal until Arca articulates and provides support for the purported benefits to the markets and long-term investors that the Program will provide.

B. <u>It is unclear who pays the Program fee</u>

There is some ambiguity around the source of funding for Arca's LMM incentive Program. The terms of the Program are set forth in proposed new NYSE Arca Equities Rule

[9] The need for a trading volume standard is obvious as the insufficiency of LMM compensation is directly tied to lack of trading volume. We also believe a market quality standard could make sense. Arca makes the point that incentivizing LMMs is important because LMMs play a critical role in promoting "a consistent, fair, and orderly market in ETPs on the Exchange." *See supra* note 5 and accompanying text. That said, some ETPs trade without an LMM or entity serving in a similar capacity. If an ETP without an LMM has sufficient MM activity to generate a consistent, fair, and orderly market, then there is no compelling rationale for the issuer to pay for an LMM, and such payments should not be permitted.

[10] *See* NYSE Arca Equities Rule 7.24.

8.800. Paragraph (c) of the Rule states that the fee for participating in the Program, known as the "Optional Incentive Fee," "shall be paid *by the issuer* to the Exchange" (emphasis added). The term "issuer" is not defined in Rule 8.800 or anywhere else in the NYSE Arca Equities Rules. In common parlance, the "issuer" of a listed ETF security is the ETF itself. However, it appears from the context in which the term is used in Rule 8.800 and in the Proposing Release generally that Arca intends the term "issuer" to mean the sponsor of an eligible ETP.[11]

It is vitally important that Arca clarify the source of funding for the Program. If the ETP pays the fee, the amount of the fee will be incorporated in the fund's expense ratio and will be borne by the fund's shareholders, raising their cost of ownership. It is unlikely that the amount the Program might save investors in the form of narrower spreads would offset the increase in expense ratio. Moreover, the bulk of any savings that would result from the narrowing of spreads would accrue to frequent traders, while long-term buy-and-hold investors, because they trade infrequently or not at all, would see little or no savings in spread costs to offset the increased expense ratio.

III. Conclusion

For the reasons discussed above, we do not support the Proposal as currently structured.

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

Sincerely,

/s/ Gus Sauter
Managing Director and Chief Investment Officer

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

[11] For example, paragraph (b) of the Rule states that "[a]n issuer may not have more than five existing ETPs . . . participate in the Fixed Incentive Program."