Vanguard®

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Via Electronic Submission

August 16, 2012

Ms. Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Nasdaq and NYSE Arca Market Maker Incentive Programs
File Numbers SR-NASDAQ-2012-043 and SR-NYSEArca-2012-37
Release No. 34-66765

Dear Ms. Murphy:

Vanguard appreciates the opportunity to provide the Securities and Exchange Commission (the "Commission") with our views on two proposals that would permit the NASDAQ Stock Market LLC ("Nasdaq") and New York Stock Exchange Arca, Inc. ("Arca"), respectively, to implement issuer-financed market maker incentive programs. The listed companies eligible to participate in each of the proposed programs are primarily exchange-traded funds ("ETFs"). As of July 31, 2012, Vanguard was the sponsor of 64 ETFs listed on either Nasdaq or Arca, with collective assets of approximately $215 billion.

The Nasdaq proposal, originally published by the Commission for public comment in a release dated April 6, 2012, would create a pilot program under which an ETF sponsor could pay money to Nasdaq that in turn would be paid to market makers who meet certain criteria when publishing quotes and executing trades in the sponsor's designated ETFs (the "Nasdaq Program").[1]

The Arca proposal, originally published by the Commission for public comment in a release dated May 11, 2012, would create a pilot program under which an ETF sponsor could pay money to Arca that in turn would be paid to the market maker who agrees to serve as lead market maker for the sponsor's designated ETFs (the "Arca Program").[2]

Vanguard and various other interested parties submitted comment letters on the Nasdaq Program and the Arca Program (collectively, the "Programs"). After the conclusion of the

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[1] Securities Exchange Act Release No. 66765 (April 6, 2012).

[2] Securities Exchange Act Release No. 66966 (May 11, 2012).

comment periods for the Programs, the Commission published an order on July 17, 2012 instituting proceedings to determine whether to approve or disapprove the Programs.[3] The order solicited additional public comment on the Programs. This letter is submitted in response to that request for comment.

As we noted in our previous comment letters, issuer payments to market makers have been prohibited, for good reason, since at least 1973.[4] We believe that exceptions to that prohibition, such as those proposed by Nasdaq and Arca, should be made only if the rationale is compelling, the exception is narrowly tailored to accomplish an important public policy goal (such as providing demonstrable benefits to long-term investors), and the benefits outweigh the harms. For the reasons set forth below, we are not convinced that either Arca or Nasdaq has met this standard.

Vanguard expressed many concerns about issuer-financed market maker incentive programs in our earlier comment letters. Briefly, those concerns include:

- Issuer payments to market makers have the potential to distort market forces, resulting in spreads and prices that do not reflect actual supply and demand.
- Issuer payments to market makers could lead to diminished market making activity and/or wider spreads in ETFs that are ineligible to, or choose not to, participate in the Programs.
- Issuer payments to market makers could create a pay-to-play environment, effectively forcing issuers to pay up to maintain quality markets for their eligible ETFs.[5]

Another concern we have about issuer-financed market maker incentive programs is that they are likely to be detrimental to long-term buy-and-hold investors. Although the source of payment for both the Nasdaq and Arca Programs is the ETF sponsor, rather than the ETF, we believe it is likely that ETF sponsors would seek to recoup those costs in some way from the ETF and its shareholders.[6] This recoupment might occur either through an increase in a fund's non-advisory fees or, perhaps more likely, through an ETF sponsor's resistance to the board's efforts to lower fees over time.[7]

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[3] *Order Instituting Proceedings to Determine Whether to Approve or Disapprove Proposed Rule Changes Relating to Market Maker Incentive Programs for Certain Exchange-Traded Products,* Securities Exchange Act Release No. 67411 (July 11, 2012) .

[4] Vanguard's comment letter on the Nasdaq 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.

[5] These concerns were described in more detail in our comment letter on the Nasdaq Program. *See id.* In addition, we expressed specific concerns about certain aspects of the Arca Program in our comment letter regarding that proposal. *See* http://www.sec.gov/comments/sr-nysearca-2012-37/nysearca201237-1.pdf.

[6] NYSE Euronext has acknowledged this possibility in its August 14, 2012 letter responding to comments on the Arca Program. *See* http://www.sec.gov/comments/sr-nysearca-2012-37/nysearca201237-6.pdf ("[I]f the fund sponsor acting within its fiduciary duty determines that investors would benefit from narrower spreads by inclusion in the Pilot Program, the Exchange does not oppose passing through [the Program] charges to fund investors.").

[7] In the case of an ETF that is not subject to the Investment Company Act of 1940 ("Act"), recoupment could come in the form of an increased management fee. In the case of an ETF that is subject to the Act, an increase in the

It would not be in the public interest for ETF shareholders to bear the costs of the Nasdaq and Arca Programs – even if they have the salutary effect of narrowing spreads. Narrow spreads primarily benefit investors engaged in frequent trading strategies, whereas higher expenses primarily hurt long-term, buy-and-hold investors. In Vanguard's view, it is not in the public interest for long-term shareholders (typically retail investors) to subsidize frequent traders (typically large institutions).

For all of the reasons set forth above, Vanguard favors maintaining the existing prohibition on issuer payments to market makers. If the Commission concludes that either or both Programs warrant an exception to the prohibition, we strongly recommend that the Programs be very narrowly drawn to limit the negative effects described above. For example, Program eligibility could be limited to newly created ETFs in an effort to give them an opportunity to "gain traction" in a crowded and competitive ETF marketplace. As proposed, however, the Programs are not limited in scope. Any ETF listed on the Arca exchange could participate in Arca's Program. The Nasdaq Program's eligibility criteria are so broad that well over 90% of listed ETFs would qualify to participate.

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

Sincerely,

/s/

F. William McNabb
Chairman and Chief Executive Officer

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
Norm Champ, Director, Division of Investment Management
Robert W. Cook, Director, Division of Trading and Markets
Barry I. Pershkow, Senior Special Counsel (ETFs)

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fund's advisory fee or 12b-1 fee (assuming Rule 12b-1 applies) would require shareholder approval, an unlikely scenario. However, non-advisory fees can be increased without a shareholder vote if the board approves. We believe that a vigilant board would deny such an increase if it were able to draw a connection between the ETF's participation in a Program and the sponsor's request for a fee increase – but that connection often will not be obvious.