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April 26, 2013

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

RE: SR-NYSEArca-2013-34 / Pilot Program for Issuers of Certain Exchange-Traded Products Proposed by NYSE Arca, Inc.

Dear Ms. Murphy,

Thank you for this opportunity to comment on SR-NYSEArca-2013-34.[1] My expertise is based on several publications and ongoing research on various economic and legal issues relating to market making.[2] In response to the solicitation of comments by the U.S. Securities and Exchange Commission,[3] I am in favor of approving the proposed pilot program in its existing form. Furthermore, given the SEC's approval of a NASDAQ pilot program with a similar purpose but somewhat different

[1] The views expressed in this comment letter are those of the author only, who is solely responsible for their content, and not necessarily those of the Lowell Milken Institute for Business Law and Policy at UCLA School of Law, UCLA School of Law generally, or any other of its faculty or staff. Please note that this comment letter is largely based on my forthcoming article in the *University of Pennsylvania Journal of Business Law* and my prior comment letter on the similar initiatives proposed by NASDAQ and NYSE Arca last year. Stanislav Dolgopolov, *Linking the Securities Market Structure and Capital Formation: Incentives for Market Makers?*, U. PA. J. BUS. L. (forthcoming), *available at* http://ssrn.com/abstract=2169601; Letter from Stanislav Dolgopolov, Assistant Adjunct Professor & Lowell Milken Inst. Law Teaching Fellow, UCLA Sch. of Law, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 15, 2012), *available at* http://www.sec.gov/comments/sr-nasdaq-2012-043/nasdaq2012043-22.pdf.

[2] Stanislav Dolgopolov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U. L. REV. 83 (2004); Stanislav Dolgopolov, *Risks and Hedges of Providing Liquidity in Complex Securities: The Impact of Insider Trading on Options Market Makers*, 15 FORDHAM J. CORP. & FIN. L. 387 (2010); Stanislav Dolgopolov, *A Two-Sided Loyalty?: Exploring the Boundaries of Fiduciary Duties of Market Makers*, 12 U.C. DAVIS BUS. L.J. 31 (2011); Stanislav Dolgopolov, *Insider Trading, Informed Trading, and Market Making: Liquidity of Securities Markets in the Zero-Sum Game*, 3 WM. & MARY BUS. L. REV. 1 (2012); Stanislav Dolgopolov, *Providing Liquidity in a High-Frequency World: Trading Obligations and Privileges of Market Makers and a Private Right of Action*, BROOK. J. CORP. FIN. & COM. L. (forthcoming), *available at* http://ssrn.com/abstract=2032134.

[3] Notice of Filing of a Proposed Rule Change by NYSE Arca, Inc. To Implement a One-Year Pilot Program for Issuers of Certain Exchange-Traded Products, Exchange Act Release No. 69,335, 78 Fed. Reg. 21,681 (Apr. 5, 2013) [hereinafter Notice of Filing Release for NYSE Arca].

features,[4] their coexistence would allow making inferences about optimizing issuer-to-market maker compensation arrangements.

Under certain circumstances, the availability of payments from an issuer to a market maker has a tangible economic rationale. Although there are some concerns that such payments represent a "subsidy,"[5] this term should not necessarily have a negative connotation. Several sources have pointed out that liquidity in securities markets has characteristics of a public good / positive externality, and, accordingly, the function of providing liquidity has to be subsidized in certain situations in order to improve economic welfare. To illustrate, one study gave the following description of this concept: "In general, liquidity provision represents a positive externality in that traders who commit capital to make markets are not fully compensated for their liquidity services. While the usual solution to this inefficiency is a Pigovian subsidy, the form that this payment should take is less clear."[6] In other words, a subsidy can increase "the size of the pie."

Historically, market makers have often enjoyed indirect subsidies in the form of time, information, fee, order flow allocation, and other advantages in exchange for their trading obligations, such as the affirmative obligation to maintain a proper market or the negative obligation to refrain from proprietary trading in certain situations. This phenomenon is also consistent with the concept of liquidity as a public good / positive externality. Given that some of these *indirect* subsidies may be abused,[7] perhaps a *direct* subsidy in the form of regular payments from an issuer to a market maker has a clear advantage in terms of transparency—especially when this compensation flows through and is monitored by the trading venue in question. Furthermore, indirect subsidies to market markets, which feed almost exclusively on trading volume,[8] tend to be less valuable in the case of less liquid securities.[9] For the

[4] Order Granting Approval of a Proposed Rule Change by NASDAQ Stock Market LLC To Establish the Market Quality Program, Exchange Act Release No. 69,195, 78 Fed. Reg. 18,393 (Mar. 20, 2013) [hereinafter Approval Release for NASDAQ].

[5] *See* Order Instituting Proceedings To Determine Whether To Approve or Disapprove Proposed Rule Changes by NASDAQ Stock Market LLC and NYSE Arca, Inc. Relating to Market Making Incentive Programs for Certain Exchange-Traded Products, Exchange Act Release No. 67,4111, 77 Fed. Reg. 42,052, 42,069 (July 11, 2012) [hereinafter Order Instituting Proceedings].

[6] Kumar Venkataraman & Andrew C. Waisburd, *The Value of the Designated Market Maker*, 42 J. FIN. & QUANT. ANALYSIS 735, 755 (2007); *see also* Kalman J. Cohen et al., *The Impact of Designated Market Makers on Security Prices*, 1 J. BANKING & FIN. 219, 245 (1977) ("[Price] stabilization [by designated market makers] is a public good type external economy to investors."); Jennifer Huang & Jiang Wang, *Market Liquidity, Asset Prices, and Welfare*, 95 J. FIN. ECON. 107, 109 (2010) ("In our model, trading and liquidity provision generate externalities. A trader's participation in the market also benefits his potential counterparties, and a market maker's supply of liquidity helps all potential traders. . . . [I]n general, market mechanism fails to properly internalize these externalities and thus leads to inefficient supply of liquidity in the market."); Wen Mao & Michael S. Pagano, *Specialists as Risk Managers: The Competition Between Intermediated and Non-Intermediated Markets*, 35 J. BANKING & FIN. 51, 64 (2011) ("A specialist's [order execution] risk management service has some attributes of a public good. . . . If specialists cannot recoup the full value of this service directly from their market-making activities, then . . . all market participants might benefit if some form of institutional support was provided to these specialists . . . ."); Johannes A. Skjeltorp & Bernt Arne Ødegaard, Why Do Listed Firms Pay for Market Making in Their Own Stock? 16, 30 (May 2012) (unpublished manuscript) (on file with author), *available at* http://ssrn.com/abstract=1944057 ("[T]here may be an externality from hiring a [designated market maker by an issuer] in the sense that 'liquidity attracts liquidity.' . . . [G]iven the public goods nature of liquidity . . . it may be desirable to subsidize liquidity provision in equity markets.").

[7] One illustration of such abuses is of course the scandal involving NYSE specialists. *See In re* NYSE Specialists Sec. Litig., 405 F. Supp. 2d 281 (S.D.N.Y. 2005), *aff'd in part, rev'd in part*, 503 F.3d 89 (2d Cir. 2007), *remanded to* 260 F.R.D. 55 (S.D.N.Y. 2009); Finnerty, Initial Decision Release No. 381, 96 SEC Docket 1098 (ALJ July 13, 2009).

[8] Reduced fees or other subsidies to market makers offered by trading venues themselves may come from listing fees (i.e., ultimately borne by issuers) or market data revenues (i.e., ultimately borne by participants in the trading process).

same reason, even the maker-taker model, in which incentives for providing liquidity *are* transparent, may be supplemented by payments from an issuer to a market maker in order to increase economic efficiency.[10] While one commentator on the prior NASDAQ proposal focused on externalities during the initial stage of a security's lifecycle,[11] it is entirely possible that a continued subsidization of market making activities may be required at later stages—depending on the liquidity characteristics of the security in question—in order to increase economic efficiency. The proposal by NYSE Arca also takes this factor into account by requiring an automatic withdrawal from the program once a certain trading volume threshold is achieved.[12]

Several empirical studies argue that the imposition of market making obligations in exchange for certain privileges tends to enhance market quality,[13] and this evidence points to improvements in economic efficiency rather than mere wealth transfers. The existence of these studies also strengthens NYSE Arca's claim that "there is ample evidence, along with logical inference, to support the assertion

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[9] As an illustration, if a market maker has a one-second "advance look" at incoming orders, this advantage is unlikely to be very valuable for an infrequently traded security, as opposed to a very liquid security.

[10] This concern is illustrated by an NYSE executive's statement in the context of small cap stocks:

> One of the circular issues is that there's, in some of these [small cap] names, not—we're paying out all the revenue that we generate and it's not necessarily enough to help get the liquidity to where we would like it to be. That's part of the reason for why we think the experiment of also letting issuers compensate market makers could help, because in some circumstances, we're already paying all the revenue we have because most of that is on a per-transaction basis and these issues don't trade very frequently. It doesn't generate enough revenue to necessarily incentivize the liquidity providers.

How Roadblocks in Public Markets Prevent Job Creation on Main Street, Hearing Before the Subcomm. on TARP, Fin. Servs. & Bailouts of Pub. & Private Programs of the H. Comm. on Oversight & Gov't Reform, 112th Cong. 35 (2012) (remarks of Joseph Mecane, Executive Vice President and Chief Administrative Officer, U.S. Markets, NYSE Euronext).

[11] Albert J. Menkveld, Market Quality Program Proposal NASDAQ (SR-NASDAQ-2012-043): A Comment 2 (May 2, 2012), *available at* http://www.sec.gov/comments/sr-nasdaq-2012-043/nasdaq2012043-12.pdf ("If, at launch, a particular security's liquidity supply is uncertain, investors might be trapped in a 'bad equilibrium' [but if] future liquidity is less uncertain, and investors participate; the 'good equilibrium' is reached. This participation externality is well-understood in the finance literature . . . .").

[12] Notice of Filing Release for NYSE Arca, *supra* note 3, at 21,687.

[13] Amber Anand & Daniel G. Weaver, *The Value of the Specialist: Empirical Evidence from the CBOE*, 9 J. FIN. MKTS. 100, 102–04 (2006) (analyzing transactions in equity options on the Chicago Board Options Exchange after the introduction of designated primary market makers, entities with affirmative obligations and informational and order flow allocation privileges, and finding an improvement in market quality); Rafi Eldor et al., *The Contribution of Market Makers to Liquidity and Efficiency of Options Trading in Electronic Markets*, 30 J. BANKING & FIN. 2025, 2025, 2029–31 (2006) (analyzing transactions in foreign exchange rate options on the Tel Aviv Stock Exchange after the introduction of market makers, entities with affirmative obligations that receive rebates on trading and clearance fees together with direct cash payments from the trading venue, and finding an improvement in market quality and efficiency); M. Nimalendran & Giovanni Petrella, *Do Thinly-Traded Stocks Benefit from Specialist Intervention?*, 27 J. BANKING & FIN. 1823, 1829–30, 1851–52 (2003) (analyzing transactions in stocks on the Italian Stock Exchange and finding that the existence of specialists, entities with affirmative obligations that pay lower trading fees and may be directly compensated by issuers, is associated with improved market quality); Marios A. Panayides, *Affirmative Obligations and Market Making with Inventory*, 86 J. FIN. ECON. 513, 513 (2007) (analyzing transactions in stocks on the New York Stock Exchange, finding that affirmative obligations of specialists, entities that enjoyed several important privileges, are associated with better market quality, and arguing that their affiliated costs are covered by profits from discretionary trading); Narayan Y. Naik & Pradeep K. Yadav, *Trading Costs of Public Investors with Obligatory and Voluntary Market-Making: Evidence from Market Reforms* 1, 17, 35 (Eur. Fin. Ass'n, Annual Conference Paper No. 408, 2003), *available at* http://ssrn.com/abstract=424982 (analyzing transactions in stocks on the London Stock Exchange and arguing that the switch from obligatory to voluntary market making together with the abolition of certain informational privileges had an adverse effect on the price stabilization function played by dealers).

that the presence of an obligated and accountable liquidity provider leads to superior market quality and thus benefits long-term investors."[14] Furthermore, statements that question or attack the desirability of trading obligations of market makers—notably, the affirmative obligation[15]—appear to be misguided, and they seem to overemphasize extreme scenarios.

One important difference between the proposed program for NYSE Arca and the approved program for NASDAQ is that the former contemplates the existence of just *one* market maker being compensated by a particular security's issuer,[16] while the latter allows *multiple* market makers to be eligible for such payments.[17] Although there have been some concerns about the approach chosen by NYSE Arca as anticompetitive,[18] there are arguments in its favor as well. Indeed, one study "suggest[ed] that *paying* multiple [designated market makers as] stabilizers for a security would be inefficient because of the 'free rider' possibilities inherent in the production of stabilization."[19] A recent comment similarly maintained that "[a]ssigning only one eligible market maker for receipt of the incentive payment . . . maximizes the available incentive and assures accountability [while] diffus[ing] the incentive across multiple market makers may ultimately reduce the effectiveness of the incentive as well as lessen the accountability of any one market maker."[20] However, in my opinion, concerns about free-riding / accountability *and* competition are likely to be mitigated by the specificity of the eligibility criteria for market makers contemplated by the proposed program for NYSE Arca and the approved program for NASDAQ. In any instance, the coexistence of these two pilot programs for similar securities would be a valuable opportunity to compare such alternative arrangements and obtain data for a comprehensive empirical study. In addition, NYSE Arca argued that "its proposed payment . . . might not be sufficient if it had to be divided among multiple Market Makers,"[21] which also appears to be a valid concern.

Of course, the involvement of market makers in manipulative schemes in cooperation with issuers and their insiders is not an unknown phenomenon in the United States, especially in the context of illiquid securities,[22] but perhaps the administration of such incentive programs by trading venues, as proposed by NYSE Arca, would be a mitigating factor. As suggested decades ago, "To avoid the possibility of stock manipulation, the listing corporation should contract for stabilization with the exchange rather

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[14] Notice of Filing Release for NYSE Arca, *supra* note 3, at 21,683.

[15] *See, e.g.*, *Examining the Efficiency, Stability, and Integrity of the U.S. Capital Markets: J. Hearing Before the Subcomm. on Sec., Ins., & Inv. of the S. Comm. on Banking, Hous., & Urban Affairs and the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 111th Cong. 41 (2011) (remarks of Manoj Narang, Chief Executive Officer, Tradeworx, Inc.) ("I cannot think of any empirical evidence that market maker obligations actually matter in practice."); Hans R. Stoll, *Reconsidering the Affirmative Obligation of Market Makers*, FIN. ANALYSTS J., Sept. / Oct. 1998, at 72, 80 ("That an affirmative obligation reduces volatility or makes markets more efficient is not evident. . . . Markets will function well without an affirmative obligation. Market makers need no regulatory obligations and should not receive special privileges."); Harold Bradley & Robert E. Litan, Choking the Recovery: Why New Growth Companies Aren't Going Public and Unrecognized Risks of Future Market Disruptions 66 (Nov. 12, 2010) (unpublished manuscript, on file with author), *available at* http://www.kauffman.org/uploadedFiles/etf_study_11-8-10.pdf ("History shows that affirmative obligations affirm only intermediaries' profits.").

[16] Notice of Filing Release for NYSE Arca, *supra* note 3, at 21,686.

[17] Approval Release for NASDAQ, *supra* note 4, at 18,394.

[18] Order Instituting Proceedings, *supra* note 5, at 42,064–65.

[19] Cohen et al., *supra* note 6, at 243.

[20] Letter from Andrew Stevens, Legal Counsel, IMC Chi., LLC d/b/a IMC Fin. Mkts., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 7 (Aug. 16, 2012), *available at* http://www.sec.gov/comments/sr-nysearca-2012-37/nysearca201237-10.pdf.

[21] Notice of Filing Release for NYSE Arca, *supra* note 3, at 21,686 n.19.

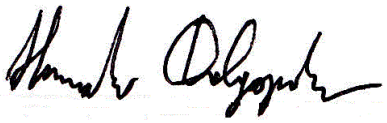
[22] *See, e.g.*, United States v. Rosen, 409 F.3d 535, 538 (2d Cir. 2005); United States v. Manas, 272 F.3d 159, 162 (2d Cir. 2001); United States v. Graulich, No. 93-1061, 1994 U.S. App. LEXIS 25466, at *2–4 (10th Cir. Sept. 13, 1994).

than directly with [designated market makers as] stabilizers. The exchange should be responsible for choosing stabilizers and regulating them."[23] More generally, the involvement of trading venues in administering and monitoring such compensation arrangements is likely to be a bonding mechanism that puts into play their reputational capital and an additional level of scrutiny. Although they are not completely unbiased parties, trading venues still have an incentive to go after and prevent abuses. Arguably, manipulative schemes involving market makers and issuers or their insiders have been more prominent in over-the-counter markets rather than on organized securities exchanges, which would also favor the proposed type of intermediation.

To the extent that the program proposed by NYSE Arca promotes the adoption of trading obligations that enhance liquidity and push it closer to the socially optimal level, this change is likely to promote economic efficiency. Of course, there are certain conflicts of interest inherent in the mechanism of payments from an issuer to a market maker, perhaps even in the context of exchange-traded products, but the choice is among imperfect alternatives. Furthermore, while it is hard to predict the magnitude of the overall impact of the proposed programs on capital formation with respect to component securities, this pilot-basis experimentation is still desirable. Perhaps some valuable lessons could be learned about the feasibility of such arrangements for small cap stocks, as opposed to exchange-traded products.

Thank you again for providing an opportunity to comment on this important issue.

Sincerely,



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[23] Cohen et al., *supra* note 6, at 243.