

CORRECTED TO CONFORM TO THE FEDERAL REGISTER VERSION

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-68515; File No. SR-NASDAQ-2012-137)

December 21, 2012

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of a Proposed Rule Change and Amendment No. 1 Thereto to Establish the Market Quality Program

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on December 7, 2012, The NASDAQ Stock Market LLC (“NASDAQ” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III, below, which Items have been prepared by the Exchange. On December 20, 2012, the Exchange submitted Amendment No. 1 to the proposed rule change, which replaces and supersedes the proposed rule change in its entirety. The Commission is publishing this notice to solicit comments on the proposed rule change, as modified by Amendment No. 1 thereto, from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NASDAQ is filing with the Commission a proposal to add new Rule 5950 (Market Quality Program) to enable market makers that voluntarily commit to and do in fact enhance the market quality (quoted spread and liquidity) of certain securities listed on the Exchange to qualify for a fee credit pursuant to the Exchange’s Market Quality Program and to exempt the Market Quality Program from Rule 2460 (Payment for Market Making). NASDAQ believes this

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

voluntary program will benefit investors, issuers or companies, and market participants by significantly enhancing the quality of the market and trading in such listed securities.

The Market Quality Program set forth in Rule 5950 will be effective for a one year pilot period beginning from the date of implementation of the program. During the pilot, NASDAQ will periodically provide information to the Commission about market quality in respect of the Market Quality Program.

The text of the proposed rule change is available from NASDAQ's website at <http://nasdaq.cchwallstreet.com/Filings/>, at NASDAQ's principal office, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASDAQ included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASDAQ has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

This Amendment No.1 to SR-NASDAQ-2012-137 replaces and supercedes [sic] SR-NASDAQ-2012-137 in its entirety.<sup>3</sup>

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<sup>3</sup> SR-NASDAQ-2012-137 replaced SR-NASDAQ-2012-043, which was withdrawn by the Exchange. See Securities Exchange Act Release Nos. 66765 (April 6, 2012), 77 FR 22042 (April 12, 2012)(SR-NASDAQ-2012-043)(notice of filing); and 68378 (December 6, 2012), 77 FR 74042 (December 12, 2012)(notice of withdrawal). Attached hereto is Exhibit 4 that reflects the changes made to Exhibit 5. The Commission notes that Exhibit 4 is attached to the filing, not to this Notice.

The purpose of the filing is to propose new Rule 5950 to enable Market Makers<sup>4</sup> that enhance the market quality of certain securities listed on the Exchange (known as “targeted securities”) and thereby qualify for a fee credit pursuant to the Market Quality Program (“MQP” or “Program”) and to exempt the Program from Rule 2460.

Proposed Rule 5950 will be effective for a one year pilot period. The pilot period will commence when the Market Quality Program is implemented by the Exchange and an MQP Company,<sup>5</sup> on behalf of an MQP security, and one or more related Market Makers are accepted into the MQP in respect of a security listed pursuant to the Program (“MQP Security”).<sup>6</sup> The pilot program will, unless extended, end one year after implementation.<sup>7</sup> During the pilot, the

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<sup>4</sup> The term “Market Maker” is defined in Rule 5005(a)(24) as a dealer that, with respect to a security, holds itself out (by entering quotations in the NASDAQ Market Center) as being willing to buy and sell such security for its own account on a regular and continuous basis and that is registered as such.

<sup>5</sup> The term “MQP Company” is defined in proposed Rule 5950(e)(5) as the trust or company housing the Exchange Traded Fund or, if the Exchange Traded Fund is not a series of a trust or company, then the Exchange Traded Fund itself. MQP Fees for MQP Securities will be paid by the Sponsors associated with the MQP Companies. The term Sponsor means the registered investment adviser that provides investment management services to an MQP Company or any of such adviser’s parents or subsidiaries.

<sup>6</sup> The term “MQP Security” is defined in proposed Rule 5950(e)(1) as an Exchange Traded Fund (“ETF”) security issued by an MQP Company that meets all of the requirements to be listed on NASDAQ pursuant to Rule 5705. For the definition of ETF, see proposed Rule 5950(e)(2).

<sup>7</sup> The Exchange believes that, based on discussions with the Financial Industry Regulatory Authority (“FINRA”), FINRA intends to file an immediately effective rule change that would exempt from FINRA Rule 5250 exchange programs that are approved by the Commission. The Exchange notes that FINRA Rule 5250 does not preclude the Exchange from any action, but precludes FINRA members (not all Exchange members are FINRA members) from directly or indirectly accepting payment or consideration from an issuer of a security for acting as a market maker. See Securities Exchange Act Release Nos. 60534 (August 19, 2009), 74 FR 44410 (August 28, 2009)(SR-FINRA-2009-036)(order approving proposal to adopt NASD Rule 2460 without substantive change into the Consolidated FINRA Rulebook as Rule 5250); and 38812 (July 3, 1997), 62 FR 37105 (July 10, 1997)(SR-NASD-97-29)(order approving adoption of NASD Rule 2460; FINRA Rule 5250 and NASDAQ Rule 2460 are based on NASD Rule 2460)(the

Exchange will periodically provide information to the Commission about market quality in respect of the MQP.<sup>8</sup>

### Background

The proposed Market Quality Program is a voluntary program designed to promote market quality in MQP Securities.<sup>9</sup> An MQP Company may list an eligible MQP Security on NASDAQ and in addition to the standard (non-MQP) NASDAQ listing fee as set forth in the Rule 5000 Series (consisting of Rules 5000-5999),<sup>10</sup> a Sponsor may pay a fee (“MQP Fee”) in

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“1997 order”). Being mindful of the concern in the 1997 order about investor confidence and market integrity, the Exchange designed the MQP Program to be highly transparent, with: clear public notification requirements; clear entry, continuation, and termination requirements; clear market maker accountability standards; and, perhaps most importantly, clear market quality (liquidity) enhancement standards that benefit investors and market participants.

The Exchange has a provision in its Rule 2460 that is, in respect of Exchange members, largely similar to FINRA Rule 5250. See Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006)(File No. 10-131) (order approving registration of The NASDAQ Stock Market LLC as a national securities exchange and adopting Rule 2460). As discussed in the body of the proposal, the Exchange proposes to modify Rule 2460 so that it is not applicable to the MQP.

<sup>8</sup> As the Exchange notes in the filing, the goal is to expand the MQP, if successful, to small cap stocks that may benefit from liquidity enhancement and in turn help to promote economic expansion. To expand the MQP in this fashion, the Exchange will need to file a new proposed rule change with the Commission.

<sup>9</sup> The Exchange notes that MQP Securities do not encompass derivatives on such securities.

<sup>10</sup> The Rule 5000 Series contains rules related to the qualification, listing and delisting of Companies on NASDAQ. The Rule 5100 Series discusses NASDAQ’s general regulatory authority. The Rule 5200 Series sets forth the procedures and prerequisites for gaining a listing on NASDAQ, as well as the disclosure obligations of listed Companies. The Rule 5300, 5400, and 5500 Series contain the specific quantitative listing requirements for listing on the Global Select, Global Market, and Capital Market, respectively. The corporate governance requirements applicable to all Companies are contained in the Rule 5600 Series. Special listing requirements for securities other than common or preferred stock and warrants are contained in the Rule 5700 Series. The consequences of a failure to meet NASDAQ’s listing standards are contained in the Rule 5800 Series. Finally, listing fees are described in the Rule 5900 Series.

order for the MQP Company, on behalf of an MQP Security, to participate in the Program. The MQP Fee will be credited to NASDAQ's General Fund. NASDAQ will incentivize one or more Market Makers in the MQP Security ("MQP Market Maker") to enhance the market quality of the MQP Security. Subject to the conditions set forth in this rule, out of its General Fund NASDAQ will credit ("MQP Credit") one or more MQP Market Makers that make a quality market in the MQP Security pursuant to the Program.<sup>11</sup> The recipients and the size of their credits will be determined solely by NASDAQ pursuant to objective criteria; issuers will have no role in selecting the recipients or in determining the specific amount, if any, of their credits.

#### The Need for the MQP

The Exchange believes that the MQP will be beneficial to the financial markets, to market participants including traders and investors, and to the economy in general. First, the MQP will encourage narrow spreads and liquid markets in situations that generally have not been, or may not be, conducive to naturally having such markets. The securities that comprise these markets may include less actively traded or less well known ETF products that are made up

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<sup>11</sup> The enhanced market quality (e.g. liquidity) would, as discussed below, emanate from market quality standards for MQP Market Makers that include, for example, posting a market in an MQP Security that is no wider on the offer side and no wider on the bid side than 2% away from NBBO. Proposed Rule 5950(c)(1)(B).

Other markets have considered various ways to increase liquidity in low volume securities. NYSE Euronext, for example, has advocated that a market-wide pilot program with wider spread increments for less liquid securities could be a worthwhile experiment. NYSE Euronext has also recognized that the creation of a program in which small companies could enter into agreements directly with broker-dealers or through exchanges to provide direct payments to a broker-dealer who agrees to make a market in the issuer's security is an idea that may warrant further review by FINRA and the Commission. See Testimony of Joseph Mecane, Executive Vice President, NYSE Euronext, Before the House Committee on Government Reform and Oversight, November 15, 2011. See also Securities Exchange Act Release No. 66966 (May 11, 2012), 77 FR 29419 (May 17, 2012)(SR-NYSEArca-2012-37)(notice of filing regarding Lead Market Maker incentive program).

of securities of less well known or start-up companies as components.<sup>12</sup> Second, in rewarding Market Makers that are willing to “go the extra mile” to develop liquid markets for MQP Securities,<sup>13</sup> the MQP would clearly benefit traders and investors by encouraging more quote competition, narrower spreads and greater liquidity. Third, the MQP will lower transaction costs and enhance liquidity in both ETFs and their components, making those securities more attractive to a broader range of investors. In so doing, the MQP will help companies access capital to invest and grow. And fourth, the MQP may attract smaller, less developed 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.

There is support for paid for market making (also known as “PFMM”) at the highest governmental levels. Congressman Patrick McHenry, the Chairman of the House Committee on Governmental Reform and Oversight, for example, recently 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.”<sup>14</sup>

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<sup>12</sup> These small companies and their securities (whether components of listed products like ETFs or direct listings) have been widely recognized as essential to job growth and creation and, by extension, to the health of the economy. Being included in a successful ETF can provide the stocks of these companies with enhanced liquidity and exposure, enabling them to attract investors and access capital markets to fund investment and growth.

<sup>13</sup> By imposing quality quoting requirements to enhance the quality of the market for MQP Securities, the MQP will directly impact one of the ways that Market Makers manage risk in lower tier or less liquid securities (e.g. the width of bid and offer pricing).

<sup>14</sup> See Payments to Market Makers May Improve Trading in Smaller Stocks, by Nina Mehta, Bloomberg, November 15, 2011.

In a similar vein, Robert Greifeld, Chief Executive Officer of The NASDAQ OMX Group, Inc. (“NASDAQ OMX”), has noted that unlike the United States, “[t]he U.K., Canada and Sweden all have exchange markets that serve as “incubators” for smaller companies.<sup>15</sup> The Exchange believes that the MQP proposal will, by encouraging liquid markets, enable the Exchange to similarly serve as an “incubator,” and to continue being an innovator in expanding markets to benefit market participants, traders, and investors.<sup>16</sup> The MQP would reward market makers for committing capital to securities and meeting rigorous market quality benchmarks established by the Program.<sup>17</sup> This approach has worked very successfully in overseas markets, including the NASDAQ OMX Nordic First North market (known as “First North”).

The practice of paid for market making to increase the liquidity of less liquid securities was examined by Johannes A. Skjeltorp and Bernt Arne Odegaard in a working paper from June

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The Exchange believes that by establishing specific market quality requirements in the MQP to expand quote competition and liquidity in targeted securities such as ETFs, the Program will be conducive to capital formation - not only in the targeted securities or ETFs (e.g. higher trading volume and/or creation of additional share units) but also in the individual components that make up the targeted securities (e.g. higher share trading volume). Securities that trade in active, liquid markets are less likely to suffer from mispricing (that is, a discount in pricing because of a lack of liquidity) that can diminish a company’s ability to raise capital for further investment and growth.

<sup>15</sup> See Robert Greifeld, CEO, NASDAQ OMX, Sarbox and Immigration Reform for Jobs, Wall Street Journal, October 4, 2011. For a discussion of capital formation issues in the U.S., see letters between Mary Shapiro, Chairman of the Commission and Congressman Darrel E. Issa, Chairman of the House Committee on Oversight and Governmental Reform, dated March 22, 2011, April 6, 2011, and April 29, 2011.

<sup>16</sup> See Securities Exchange Act Release No. 63270 (November 8, 2010), 75 FR 69489 (November 12, 2010)(NASDAQ-2010-141)(notice of filing and immediate effectiveness establishing the Investor Support Program to attract retail order flow to the Exchange). See also Securities Exchange Act Release No. 64437 (May 6, 2011), 76 FR 27710 (May 12, 2011)(NASDAQ-2010-059)(approval order creating a listing market, The BX Venture Market, that will have strict qualitative listing requirements and quantitative standards that would attract smaller, growth companies).

<sup>17</sup> See Testimony of Edward S. Knight, General Counsel and Executive Vice President, NASDAQ OMX Group, Before the Senate Committee on Banking, Housing, and Urban Affairs, December 1, 2011.

2011.<sup>18</sup> Skjeltorp and Odegaard examined paid for market making on the Oslo Stock Exchange, which uses a market making model that is similar to that of NASDAQ's First North market,<sup>19</sup> and noted that they "... find a significant reduction in liquidity risk and cost of capital for firms that hire a market maker. Firms that prior to hiring a market maker ... [have] a high loading on a liquidity risk factor, experience a significant reduction in liquidity risk to a level similar to that of the larger and more liquid stocks on the exchange."

About six years prior to the Skjeltorp and Odegaard article, Amber Anand, Carsten Tanggaard, and Daniel G. Weaver studied liquidity provision through paid for market making on the Stockholm Stock Exchange ("SSE"), currently named NASDAQ OMX Stockholm AB.<sup>20</sup> The researchers examined the success of fifty previously illiquid firms that were listed on the SSE and enjoyed, along with investors, the benefits of paid for market making. The researchers examined the impact of the paid market maker program and found that firms experienced "...a decreased cost of capital and significant improvements in market quality and price discovery."<sup>21</sup> The market makers were known as liquidity providers and the firms could set maximum spread widths for their stocks, as is currently done. Anand, Tanggaard, and Weaver found that

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<sup>18</sup> See 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. See also Why Designate Market Makers? Affirmative Obligations and Market Quality by Hendrik Bessembinder, Jia Hao, and Michael Lemmon, June 2011. This study suggests that future flash crashes can be avoided and social welfare enhanced by designating market makers and engaging paid for market making; and observing the positive attributes of direct payments from listed firms to designated market makers on the Stockholm Stock Exchange and Euronext Paris.

<sup>19</sup> The Exchange believes that the Skjeltorp and Odegaard article is therefore directly applicable to the First North paid for market making experience.

<sup>20</sup> 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.

<sup>21</sup> At the time of the study, SSE was owned by OMX AB. SSE merged into NASDAQ OMX in 2008 and retained its identity within the new corporate structure. The SSE paid for market making system matured into the current First North market.



following the beginning of paid for market making services, spreads narrowed by a statistically significant amount and depth increased at the inside and in the aggregate for four price levels away from the inside. The researchers found that accompanying the increase in depth was a significant increase in average trade size, suggesting that traders did not find it necessary to break up their orders to accommodate low market depth. They also found an increase in trading activity, suggesting that liquidity providers were actively trading with public customers.

More recently, Eric Noll, Executive Vice President, NASDAQ OMX, described the positive impact of paid for market making in the First North market, a European venue for smaller companies that has a program enabling companies to compensate market makers.<sup>22</sup> Mr. Noll stated that NASDAQ OMX has had “great success” in increasing liquidity in stocks on First North, and that in just five years, the First North market has grown to 141 listings with a total capitalization of 2.8 billion Euros. Twenty-two 22 First North companies have graduated to the main market since 2006.<sup>23</sup>

#### Paid for Market Making on the First North Market

The Exchange believes that commensurate with the previously-discussed studies regarding paid for market making,<sup>24</sup> it is instructive to examine the paid for market making experience on the First North market.

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<sup>22</sup> See Payments to Market Makers May Improve Trading in Smaller Stocks, by Nina Mehta, Bloomberg, November 15, 2011.

<sup>23</sup> See Testimony of Eric Noll, Executive Vice President, NASDAQ OMX Group, Before the House Committee on Government Reform and Oversight, November 15, 2011. Mr. Noll noted also that one of the unintended consequences of market fragmentation in the current U.S. securities markets has been a lack of liquidity and price discovery in listed securities outside of the top 100 traded names, and a disturbing absence of market attention paid to small growth companies by market participants. The Exchange believes that the MQP proposal offers a practical and positive solution.

<sup>24</sup> See supra notes 18, 19, and 20.

By way of background, the First North market is an alternative listing market to the NASDAQ OMX Nordic Main Market (“Main Market”).<sup>25</sup> Both First North and Main Market are subject to and regulated by European Union (“EU”) directives<sup>26</sup> and exchange rules, and are supervised and regulated by one or more Financial Services Authorities (“FSAs”).<sup>27</sup> While the Main Market is intended for listing companies that are well established, First North is intended for listing small, young or growth companies (not unlike the beneficiaries of the MQP) while providing an infrastructure and trading and settlement system that is similar to that of the Main Market. First North offers new or small public companies the benefits of listing on a public market and the potential for good markets through a paid for market making system, and is often the first step towards listing on the Main Market.<sup>28</sup>

The First North paid for market making system is based on a standard exchange-supplied contract between a listing firm and a designated market maker (“DMM”) that sets forth market obligations for the market maker. The Exchange sets forth obligations for the MQP Market

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<sup>25</sup> NASDAQ OMX Nordic, which has securities exchanges and clearing operations in the Nordic countries of Sweden, Denmark, Iceland, and Finland and Baltic countries of Latvia and Estonia, operates First North and the Main Market. For additional information, see [http://www.nasdaqomxnordic.com/about\\_us?languageId=1](http://www.nasdaqomxnordic.com/about_us?languageId=1).

<sup>26</sup> For example, the Markets in Financial Instruments Directive (“MiFID”). It should be noted that certain parts of the EU legislation, for example the Transparency Directive, only apply to companies admitted to trading on the Main Market.

<sup>27</sup> A Financial Services Authority or “FSA” is the regulator of financial services and securities exchanges in an EU country (including the Nordics) and as such is similar to the Commission in respect of involvement in market regulation and oversight.

<sup>28</sup> The First North and Main Market have increasingly higher listing standards, similarly to the tiered NASDAQ listings markets. See Rule 5300, 5400, and 5500 Series regarding the Global Select, Global Market, and Capital Market, respectively. In a similarly tiered fashion, between First North and Main Market is an intermediary market known as First North Premiere (a segment of First North) that is designed to help companies seeking higher investor visibility and/or preparation for Main Market listing.

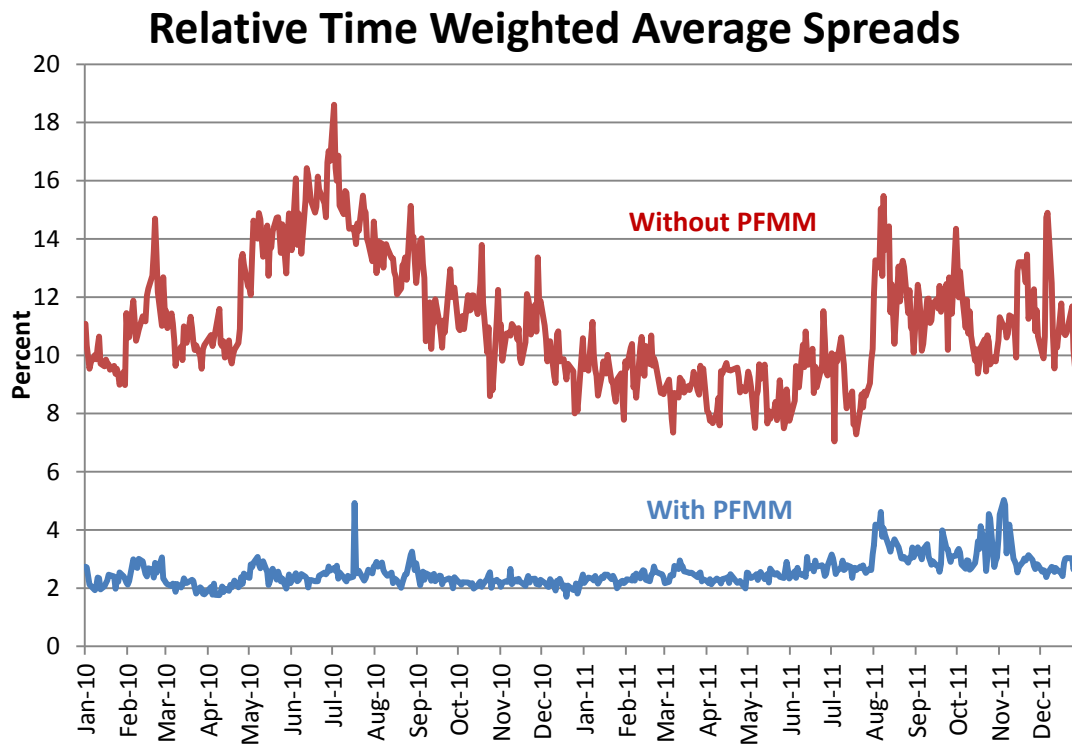
Makers (as well as MQP Companies) in proposed Rule 5950 in the belief that this provides the greatest amount of transparency, and accountability, for all that wish to participate in the MQP.

The paid for market making model on NASDAQ's First North has operated since 2002 and has been demonstrably successful to the benefit of issuers and investors, without material regulatory issues. One of the definitive market quality attributes associated with expansion of liquidity through paid for market making is the significant narrowing of bid/ask spreads. This phenomenon is directly and immediately beneficial for all market participants including investors and listing companies (which may also benefit from accompanying volume increase). As depicted in the chart below, in 2010 and 2011 the Relative Time Weighted Average Spread ("RTWAS")<sup>29</sup> at First North was significantly better for securities with PFMM than for those without the benefit of PFMM.

The substantial positive advantage that market participants receive from PFMM is clearly demonstrated in the chart below, showing that non-PFMM security spreads were: a) often more than four times wider than PFMM security spreads; and b) a majority of the time more than three times wider than PFMM spreads. Moreover, the spreads for stocks with PFMM were more stable through time.

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<sup>29</sup> RTWAS is the bid/ask spread relative to the stock price calculated at every NBBO change, then averaged with weights for how long each NBBO condition lasted.



A comparison of Relative Time Weighted Average Spread on First North shows the significant, consistent impact of PFMM in narrowing spreads.<sup>30</sup> This directly benefits investors in PFMM securities by lowering their transaction costs.<sup>31</sup>

<sup>30</sup> The Exchange believes that the volatility reflected on the RTWAS chart after August 2011 is due in large part to economic events in the EU.

<sup>31</sup> The Exchange believes that just as First North's positive PFMM experience is successful in its own right, so it is equally positive within the wider European liquidity enhancement (paid for market making) experience. See, for example, *How Do Designated Market Makers Create Value for Small-Caps?* by Albert J. Menkveld and Ting Wang, August 1, 2011. This analysis of the 2001 Euronext system roll-out to the Amsterdam market, where small-caps had the opportunity to hire a DMM who guaranteed a minimum liquidity supply in their stock, found an improvement in liquidity level and a reduction in liquidity risk. See also *Designated Sponsors and Bid-Ask Spreads on Xetra* by Jördis Hengelbrock, October 31, 2008. This analysis of Deutsche Börse Group's Xetra program that began in the 1990s, where issuers of less liquid stocks could contract with a Designated Sponsor to provide liquidity in a stock for a fee, found that investor costs including spreads were lower for those stocks that had at least one such dedicated Designated Sponsor.

In terms of regulation, the First North PFMM experience has not raised concerns. Based on Exchange discussions with the Office of General Counsel at NASDAQ OMX Nordic in respect of the First North market, the Exchange is not aware of regulatory oversight issues (e.g. Swedish FSA or Danish FSA) in respect of paid for market making on First North.<sup>32</sup>

The Exchange believes that the MQP will, like paid for market making on First North, achieve positive results.<sup>33</sup>

#### The Proposal - Background

The Exchange believes that this proposal would help raise investor and issuer confidence in the fairness of their transactions and the markets in general by enhancing market maker quote competition in securities on the Exchange, narrowing spreads, increasing shares available at the inside, reducing transaction costs, supporting the quality of price discovery, and promoting market transparency.<sup>34</sup>

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<sup>32</sup> Moreover, the Exchange notes that while spreads widened for stocks on all markets around the world during the height of the financial crisis in September and October 2008, First North stocks with PFMM experienced less spread widening than comparable stocks without PFMM.

<sup>33</sup> The Exchange believes that even though First North market lists equities while the proposed MQP market would emphasize listing ETF products, this does not detract from, and indeed enhances, the comparability of the First North PFMM experience to MQP. See infra note 36 (discussing the potential benefit of the unique trust structure of ETFs).

<sup>34</sup> The Commission has recognized the strong policy preference under the Act in favor of price transparency and displayed markets. See Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010) (Concept Release on Equity Market Structure).

To that end, the Exchange has recently put into place initiatives designed to expand the liquidity of certain targeted securities on transparent and displayed markets on the Exchange. See, for example, Securities Exchange Act Release No. 63270 (November 8, 2010), 75 FR 69489 (November 12, 2010)(SR-NASDAQ-2010-141)(notice of filing and immediate effectiveness of proposal to establish Investor Support Program in respect of retail or natural order flow).

As noted, the proposal would enhance the market quality of targeted securities, particularly ETFs. The Exchange believes that ETFs offer great value to retail and institutional investment communities, as reflected in their popularity as investment vehicles both in the U.S. and abroad.<sup>35</sup> ETFs offer transparency, liquidity, diversification, cost efficiency and investment flexibility to gain broad market exposure or to express a directional view as a core or satellite component to one's investment portfolio; and do so while offering investment exposure to all asset classes - many of which would otherwise be inaccessible.<sup>36</sup> Moreover, ETFs, particularly those that are equity based, also benefit listed companies. By being included in a single, diversified security, companies gain access to a greater audience of investors who may not have bought the individual stock.<sup>37</sup> This means that the markets are deeper and more liquid,

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<sup>35</sup> The Exchange notes that foreign (non-U.S.) ETFs, particularly those that are derivative-based, may have certain negative characteristics that are not present in U.S. ETFs. In some cases, under the Undertakings for Collective Investment in Transferable Securities (UCITS, Europe's equivalent of the Investment Company Act of 1940 ("1940 Act")) structure, individual firms are permitted to fulfill multiple roles within the construct of the product's trading and or creation/redemption process (e.g. the Sponsor/Issuer of a European ETF could be the same entity as the market maker, distributor, intraday Net Asset Value ("NAV") calculation agent, custodian bank and/or counterparty to any underlying asset). Under the 1940 Act, this is not permitted.

<sup>36</sup> It has been noted that since the prices of ETFs are generally linked back to the underlying securities, there is less opportunity for manipulation. See Payments to Market Makers May Improve Trading in Smaller Stocks, by Nina Mehta, Bloomberg, November 15, 2011. To that end, the Exchange notes that by definition an ETF will have an insulating wall between Market Maker and product, namely a trust structure - which is not present with other products such as equity securities - that establishes the daily NAV for an ETF. NAV reflects the per-share value of an ETF, which is based upon the performance of a fund's underlying components and methodology.

<sup>37</sup> See Testimony of Eric Noll, Executive Vice President, NASDAQ OMX, Before the Securities Subcommittee of the Senate Banking Committee October 19, 2011 ("I can tell you from personal experience that the companies that make up QQQ [(the NASDAQ-100 technology ETF)] consider it a real achievement, and certainly NASDAQ is proud of the excellence QQQ represents.").

In addition, the Exchange believes that purchasers of ETFs that find success because of increased market quality (especially where such ETFs are smaller or niche funds with

benefiting not only investors but the economy as a whole.<sup>38</sup> This proposal will allow ETFs that may not otherwise see much trading or volume<sup>39</sup> to be listed and traded on the Exchange in more liquid markets.<sup>40</sup> In that this proposal is designed to provide market quality support to smaller, less frequently traded segments of securities (ETFs), subsection (d) of proposed Rule 5950, which catalogues the reasons for termination of the MQP and is discussed at length below, indicates that an MQP Security will no longer be eligible to remain in the MQP if the security sustains an average daily trading volume (consolidated trades in all U.S. markets) (“ATV”) of one million shares or more for three consecutive months. While the Exchange originally proposed a two million shares threshold in the withdrawn MQP proposal at SR-NASDAQ-2012-

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fewer components) may choose to invest directly in the fund components after a positive ETF market quality and execution experience.

<sup>38</sup> See Testimony of Eric Noll, Executive Vice President, NASDAQ OMX, Before the House Committee on Government Reform and Oversight, November 15, 2011.

<sup>39</sup> There are a record 377 funds (273 ETFs and 104 ETNs) on the August 2012 “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. Mr. Rowland states: “The largest risk is not, however, that [the funds] may close in the future. No, the more notable risk is that they suffer from extremely poor liquidity *today*. Wide bid/ask spreads, little to no volume behind the quotes, and sleeping market makers can potentially inflict much more damage on unknowing investors than a fund closure.”

Perhaps the most astonishing statistic, which clearly shows the critical need for a rules-based liquidity-enhancement program such as the MQP, is that ETF Deathwatch list surged 131% in the past year.

<sup>40</sup> Subsection (a)(1)(C)(iv) of Proposed Rule 5950 indicates that the Exchange will post on its website a general description of the Program as implemented on a pilot basis and a fair and balanced summation of the potentially positive aspects of the Program (e.g. enhancement of liquidity and market quality in MQP Securities) as well as the potentially negative aspects and risks of the Program (e.g. possible lack of liquidity and negative price impact on MQP Securities that withdraw or are terminated from the Program), and indicates how interested parties can get additional information about products in the Program.

043, it is scaling back the threshold to one million shares to better provide NASDAQ and the Commission with an opportunity to observe the impact, if any, on MQP Securities that exceed the threshold and “graduate” from the Program. The Exchange has compiled statistics indicating that “graduation” from the Program may occur more frequently at a one million threshold than a two million threshold:

Number of ETFs with average daily volume moving from below the threshold to above, by year

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Graduates (ADV moves above 2M)	2	1	3	2	7	10	23	38	20	10	12	3
Graduates (ADV moves above 1M)	3	4	5	5	14	20	24	48	27	16	16	5

Notes:

- ADV for all ETFs was not available in all years.

- A single ETF may graduate more than once over the 12 years because they move above 1M ADV, then below for a year or more, then above again.

Moreover, while the MQP pilot is structured to initially apply only to ETFs, the goal is to expand the MQP, if successful, to small cap stocks and other similar products that may need liquidity enhancement. The Exchange believes that while this would benefit small cap MQP products and investors as well as overall market liquidity, perhaps even more importantly it would serve to help economic expansion and the economy as a whole.<sup>41</sup>

### The Proposal - Specifics

#### Proposed Rule 2460

Preliminarily, the Exchange is proposing to modify its Rule 2460, which prohibits direct or indirect payment by an issuer to a Market Maker, to indicate that Rule 2460 is not applicable to the MQP.<sup>42</sup> Specifically, the Exchange is proposing new IM-2460-1 (Market Quality

<sup>41</sup> This is clearly consistent with recent legislative action designed to create job opportunities and promote economic expansion, such as the Jumpstart Our Business Startups Act (JOBS Act).

<sup>42</sup> See Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006)(File No. 10-131)(order approving registration of The NASDAQ Stock Market LLC as a national securities exchange and adopting Rule 2460). FINRA, with whom the Exchange has an agreement regarding provision of certain regulatory services,



Program)<sup>43</sup> to state that Rule 2460 is not applicable to a member that is accepted into the Market Quality Program pursuant to Rule 5950 or to a person that is associated with such member for their conduct in connection with that program. The Exchange believes that this proposed limited clarification is proper in that it allows the MQP to go forward on a pilot basis without denigrating the basic premise of Rule 2460, which was designed to forestall problematic relationships between exchange members (e.g. market makers) and issuers. The Exchange's proposal sets forth an extensive rule-based process with clear Program requirements for issuers (MQP Companies) and clear market quality requirements for members (MQP Market Makers) that can only be effected in a lit and highly regulated exchange environment.

In the order approving NASD Rule 2460 (the 1997 order), upon which NASDAQ Rule 2460 is based (as is FINRA Rule 5250), the Commission discussed that NASD Rule 2460 preserved investor confidence, preserved the integrity of the marketplace, and established a clear standard of practice for member firms.<sup>44</sup>

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has a similar provision in FINRA Rule 5250. As discussed, the Exchange believes that FINRA intends to file an immediately effective rule change that would exempt from FINRA Rule 5250 Exchange programs that are approved by the Commission.

<sup>43</sup> IM reflects interpretive material to an Exchange rule.

<sup>44</sup> See Securities Exchange Act Release No. 38812 (July 3, 1997), 62 FR 37105 (July 10, 1997)(SR-NASD-97-29)(order approving adoption of NASD Rule 2460). In discussing the 1997 order, the Commission cited to NASD Notice to Members 75-16 (February 20, 1975); see also the letter from Kenneth S. Spierer, Attorney, Division of Market Regulation, SEC, to Mr. Jack Rubens, Monroe Securities, Inc. (May 4, 1973)(regarding acceptance of a fee or service charge from issuers in connection with making a market). See also Securities Exchange Act Release No. 39670 (February 25, 1998), File No. S7-3-98, 63 FR 9661)(notice for public comment of proposed amendments to Rule 15c2-11 under the Act in response to increasing incidents of fraud and manipulation in the OTC securities market involving thinly traded securities of thinly-capitalized issuers, known as microcap securities)(the "15c2-11 proposal"). In the 15c2-11 proposal, the Commission cited NASD Rule 2460 when discussing that microcap fraud often involves "pump and dump" operations, in which unscrupulous brokers sell the securities of less-seasoned issuers to retail customers by using high pressure sales tactics and a supply of securities under the firm's control.

The Exchange designed the MQP to meet the goals of market integrity, investor confidence, and clear member standards as discussed in the 1997 order. In particular, the Exchange designed the MQP to have precise standards for all MQP Market Makers in the Program and to be highly transparent with clear public notification requirements; with clear entry, continuation, and termination requirements; with clear Market Maker accountability standards; and, perhaps most importantly, with clear market quality (liquidity) enhancement standards that benefit investors and market participants. Additionally, NASDAQ has ensured that issuers are unable to influence the selection or retention of MQP Market Makers, or the amount of incentive credits that any particular Market Maker receives from NASDAQ. The positive aspects of the MQP are objective, clear and unambiguous.<sup>45</sup>

First, the entire MQP is clearly and accurately set forth in proposed Rule 5950. This includes the application and withdrawal process, the listing fee and credit structure, the market quality standards that an MQP Market Maker must meet and maintain to secure an MQP Credit, and the Program termination process. Second, the Exchange will provide notification on its public website regarding the variable aspects of the Program. Specifically, this notification will include: the names of the MQP Companies and the MQP Market Makers that are accepted into the Program; how many MQP Securities an MQP Company may have in the Program; the specific names of the MQP Securities that are listed pursuant to the Program; the identity of the MQP Market Makers in each MQP Security; and the amount of the supplemental MQP Fee, if

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<sup>45</sup> In addition to the clear and unambiguous MQP market quality standards promoting tighter markets and increased liquidity to the benefit of market participants, it has been demonstrated that already-established paid for market making programs in Europe have resulted in a significant and sustained reduction in spreads. As an example, securities that enjoyed PFMM in NASDAQ's First North's market have spreads that are as much as four times narrower, and are more stable, than securities without PFMM. *See supra* notes 31, 32, and 33 and related text. Narrower spreads benefit investors by lowering their transaction costs.

one is established by an MQP Company in addition to the basic MQP Fee, as discussed below. Third, MQP Securities will be traded on a highly regulated and transparent exchange, namely 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. And fourth, the MQP would encourage narrower spreads and better market quality (more liquid markets) for securities that generally have not been, or may not be, conducive to naturally having such markets. The Exchange believes that these factors, which directly benefit all market participants and investors, are instrumental to developing strong investor confidence in the MQP and the integrity of the market.

Moreover, the Exchange believes that the MQP does not implicate conflicts of interest. That is, unlike the situation that the NASD was trying to address in its Rule 2460 or NASD Notice to Members 75-16, where issuers had the ability to directly pay a market maker to illegally pump up the price of an issuer's stock, the proposed MQP does not encourage MQP Market Makers to improperly pump up prices nor, for that matter, establish any direct financial connection between MQP Market Makers and MQP Companies. First, an MQP Company must go through an MQP application process, and the Exchange must accept the MQP Company into the Program, before an MQP Company can list a product pursuant to the Program.<sup>46</sup> Second, an MQP Market Maker must go through a separate MQP application process, and the Exchange must accept an MQP Market Maker into the Program, before an MQP Market Maker can make a market in a product listed pursuant to the Program.<sup>47</sup> NASDAQ will operate both of these

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<sup>46</sup> Moreover, an MQP Company approved to be in the Program must meet both the non-MQP initial and continued listing standards (e.g. Rules 5300, 5400, 5500) and the MQP initial and continued listing standards to list a security pursuant to the MQP.

<sup>47</sup> Moreover, an MQP Market Maker must be approved to be a member on NASDAQ to be eligible for the MQP, and thereafter must attain the general market making requirements

application processes as an independent regulator, preventing either issuers or market makers from improperly influencing the ultimate outcome. Third, in terms of flow of funds, the Program is constructed so that the only way that an MQP Market Maker can earn an MQP Credit – the payment of which is administered solely by the Exchange - is to maintain a quality market in terms of the spread and liquidity of an MQP Security.<sup>48</sup> The Program does not afford any other way for an MQP Market Maker to earn an MQP Credit. If an MQP Market Maker does not earn an MQP credit, the MQP Fee remains in NASDAQ's General Fund. Fourth, in contrast to the extensive benefits of the MQP, the participation of an MQP Company in the Program is substantially limited by design. In this regard, an MQP Company is limited to making only the following determinations regarding the Program: whether to participate in the Program; what MQP Security should be in the Program; when the MQP Security should exit the Program; and the level of Supplemental Fees, if any, that should be applied. The MQP Company can never choose an MQP Market Maker, nor influence how, when, or the specific amount that an MQP Market Maker receives as credit for making a market in an MQP Security; these functions are performed solely by the Exchange according to standards set forth in the Program.<sup>49</sup> The

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(e.g. Rule 4613) and the specific MQP market quality standards to be able to attain an MQP Credit.

<sup>48</sup> One of the eligibility criteria for an MQP Market Maker to receive an MQP Credit, for example, is that the MQP Market Maker must maintain at least 2,500 shares of attributable, displayed posted liquidity on the NASDAQ Market Center that are priced no wider on the offer side and no wider on the bid side than 2% away from NBBO. Proposed Rule 5950(c)(1)(B).

Moreover, NASDAQ notes, regarding the flow of funds, that the Exchange stands between an MQP Company and an MQP Market Maker; an MQP Company cannot and does not, under any circumstances, directly pay any funds to an MQP Market Maker.

<sup>49</sup> Indeed, the Exchange will not pay an MQP Market Maker pursuant to the Program for making a market in an MQP Security; rather, the Exchange will pay an incentive out of its General Fund if - and only if - an MQP Market Maker achieves very specific, rules-based market quality objectives when otherwise making a market.

Exchange firmly believes that the clear, unambiguous, and transparent nature of the Program and its established market quality standards are counter-indicative of any inherent conflict of interest.<sup>50</sup>

Additionally, the Exchange notes that the MQP is proposed initially as a pilot program. This is significant for several reasons. First, NASDAQ is proposing the pilot as an attempt to repair a gap in market structure, namely the challenge of certain small or start-up securities lacking access to quality markets with adequate liquidity.<sup>51</sup> Second, the Exchange has agreed, as part of the MQP pilot, to submit periodic reports to the Commission about market quality in respect of the MQP. These reports will endeavor to compare, to the extent practicable, securities before and after they are in the MQP. The reports will provide information regarding, for example, volume metrics, number of MQP Market Makers in target securities, and spread size; and will help the Commission and NASDAQ to evaluate the efficacy of the Program. The Exchange will endeavor to provide similar data to the Commission about comparable ETFs that are listed on the Exchange that are not in the MQP. And third, if the Exchange desires to expand the pilot program or make the MQP permanent, the Exchange will need to file a new proposed rule change with the Commission.

The Exchange believes that the MQP proposal would help raise investor and issuer confidence in the fairness of their transactions and the markets in general by enhancing market maker quote competition in securities on the Exchange, narrowing spreads, increasing shares

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<sup>50</sup> The Exchange notes that the MQP as proposed (e.g. fully transparent and with clear market quality standards) would not be susceptible to the “pump and dump” fraud and manipulation schemes noted in the 15c2-11 proposal. See also *supra* note 36 discussing that ETFs afford less opportunity for manipulation and that the ETF trust structure acts as an insulating wall between market maker and product.

<sup>51</sup> These securities may include less actively traded or less well known ETF products that have less well known or start-up companies as components.

available at the inside, reducing transaction costs, supporting the quality of price discovery, and promoting market transparency.

#### Proposed Rule 5950 - Securities Eligible for the MQP

The MQP is available to Companies<sup>52</sup> that choose to list certain MQP Securities on the Exchange. To be eligible for listing, MQP Securities must meet the requirements to be listed on NASDAQ as an ETF pursuant to Rule 5705.<sup>53</sup> In addition, the MQP Security must meet all NASDAQ requirements for continued listing during the period of time that the MQP Security is in the MQP.<sup>54</sup>

#### Proposed Rule 5950 - Application and Withdrawal

The first step for an entity wishing to participate in the MQP by listing a security on the Exchange, and for a Market Maker wishing to participate in the MQP as an MQP Market Maker, is to submit an MQP application to the Exchange.<sup>55</sup> Once the Exchange determines that the MQP Company and the MQP Market Maker are eligible to be in the MQP according to the parameters of the proposed rule, the Exchange will indicate acceptance to the MQP Company and the MQP Market Maker. NASDAQ will provide notification on its website regarding acceptance of an MQP Company, on behalf of an MQP Security, and an MQP Market Maker into the Program.<sup>56</sup> NASDAQ may, on a Program-wide basis, limit the number of MQP

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<sup>52</sup> The term Company is defined in Rule 5005(a)(6).

<sup>53</sup> See proposed Rule 5950(e)(1) and 5950(b)(1)(B).

<sup>54</sup> Proposed Rule 5950(b)(1)(C).

<sup>55</sup> See Proposed Rule 5950(a). Thus for an MQP Company, on behalf of an MQP Security, to participate in the Program, and for an MQP Market Maker to be eligible to receive an MQP Credit for his market making activities, the Exchange must have accepted the application of each of these parties in respect of an MQP Security, and the parties must each have fulfilled their obligations pursuant to the MQP. Proposed Rule 5950 (b)(1) and (c)(1).

<sup>56</sup> Proposed Rule 5950(a)(1)(C).

Securities that any one MQP Company may have in the MQP; any limitation would be uniformly applied to all MQP Companies.<sup>57</sup> In determining to limit the number of MQP Securities per MQP Company in the MQP, NASDAQ may consider information that it believes will be of assistance to it, such as whether a restriction, if any, is in the best interest of NASDAQ, the MQP Company and the goals of the MQP, and investors.<sup>58</sup>

Moreover, to further enhance the transparency of the Program, proposed Rule 5950(a)(1)(C) indicates that NASDAQ will also provide notification on its website regarding the following: the total number of MQP Securities that any one MQP Company may have in the Program; and the names of MQP Securities that are listed on NASDAQ and the MQP Market Maker(s) in each listed MQP Security, and the dates that an MQP Company, on behalf of an MQP Security, commences participation in and withdraws or is terminated from the Program.<sup>59</sup>

An MQP Company, on behalf of an MQP Security, and an MQP Market Maker may choose to withdraw from the Program. After an MQP Company, on behalf of an MQP Security, is in the MQP for six consecutive months but less than one year, it may voluntarily withdraw

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<sup>57</sup> NASDAQ may also, on a Program-wide basis, limit the number of MQP Market Makers permitted to register in an MQP Security. NASDAQ will provide notification on its website of any such limit. If a limit is established, NASDAQ will allocate available MQP Market Maker registrations in a first-come-first-served fashion based on successful completion of an MQP Market Maker application. Proposed Rule 5950(c)(3).

<sup>58</sup> Proposed Rule 5950 (a)(1)(A) and (B). Factors that may be considered by the Exchange are set forth in subsection (a)(1)(B)(i) and include, but are not limited to, the following: the current and expected liquidity characteristics of MQP Securities; the projected initial and continuing market quality needs of MQP Securities; and the trading characteristics of MQP Securities (e.g. quoting, trading, and volume).

<sup>59</sup> See also proposed Rule 5950(a)(1)(C)(iv), whereby the Exchange will include on its website a general statement about the MQP that sets forth the potentially positive and negative aspects of the Program.

And per proposed Rule 5950(b)(1)(D), during such time that an MQP Company lists an MQP Security, the MQP Company must, on a product-specific website for each product, indicate that the product is in the MQP and provide the link to the Exchange's MQP website.

from the MQP on a quarterly basis. The MQP Company must notify NASDAQ in writing not less than one month prior to withdrawing from the MQP. NASDAQ may determine, however, to allow an MQP Company to withdraw from the MQP earlier.<sup>60</sup> After an MQP Company, on behalf of an MQP Security, is in the MQP for one year or more, it may voluntarily withdraw from the MQP on a monthly basis. The MQP Company must notify NASDAQ in writing one month prior to withdrawing.<sup>61</sup> After an MQP Market Maker is in the MQP for not less than one quarter, he may withdraw from the MQP on a quarterly basis. The MQP Market Maker must, similarly to an MQP Company, notify NASDAQ in writing one month prior to withdrawing.<sup>62</sup>

After an MQP Company, on behalf of an MQP Security, is in the MQP for one year, the MQP and all obligations and requirements of the Program will automatically continue on an annual basis unless NASDAQ terminates the Program by providing not less than one month prior notice of intent to terminate or the pilot Program is not extended or made permanent pursuant to a proposed rule change subject to filing with or approval by the Commission under Section 19(b) of the Exchange Act; the MQP Company withdraws from the Program pursuant to subsection (a)(2) of this rule; or the MQP Company is terminated from the Program pursuant to subsection (d) of Proposed Rule 5950.<sup>63</sup>

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<sup>60</sup> In making this determination, NASDAQ may take into account the volume and price movements in the MQP Security; the liquidity, size quoted, and quality of the market in the MQP Security; and any other relevant factors. Proposed Rule 5950(a)(2)(A).

<sup>61</sup> Proposed Rule 5950(a)(2)(B).

<sup>62</sup> Proposed Rule 5950(a)(2)(C). In addition, per proposed Rule 5950(a)(2)(D), NASDAQ will provide notification on its website when it receives notification that an MQP Company, on behalf of an MQP Security, or MQP Market Maker intends to withdraw from the Program, and the date of actual withdrawal or termination from the Program.

<sup>63</sup> Proposed Rule 5950(a)(2) and (a)(3). Proposed Rule 5950 (d) states that the MQP will terminate in respect of an MQP Security under the following circumstances:

(A) An MQP Security sustains an average daily trading volume (consolidated trades in all U.S. markets) (“ATV”) of one million shares or more for three consecutive months;



Proposed Rule 5950 - MQP Fees

An MQP Company seeking to participate in the MQP shall incur an annual basic MQP Fee of \$50,000 per MQP Security. The basic MQP Fee must be paid to NASDAQ prospectively on a quarterly basis.<sup>64</sup>

An MQP Company may also incur an annual supplemental MQP Fee per MQP Security. The basic MQP Fee and supplemental MQP Fee when combined may not exceed \$100,000 per year. The supplemental MQP Fee is a fee selected by an MQP Company on an annual basis, if at all. The supplemental MQP Fee must be paid to NASDAQ prospectively on a quarterly basis. The amount of the supplemental MQP Fee, if any, will be determined by the MQP Company initially per MQP Security and will remain the same for the period of a year. NASDAQ will provide notification on its website regarding the amount, if any, of any supplemental MQP Fee determined by an MQP Company per MQP Security.<sup>65</sup>

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(B) An MQP Company, on behalf of an MQP Security, withdraws from the MQP, is no longer eligible to be in the MQP pursuant to this rule, or its Sponsor ceases to make MQP Fee payments to Nasdaq;

(C) An MQP Security is delisted or is no longer eligible for the MQP;

(D) An MQP Security does not have at least one MQP Market Maker for more than one quarter; or

(E) An MQP Security does not, for two consecutive quarters, have at least one MQP Market Maker that is eligible for MQP Credit.

Moreover, subsection (d) states that MQP Credits remaining upon termination of the MQP in respect of an MQP Security will be distributed on a pro rata basis to the MQP Market Makers that made a market in such MQP Security and were eligible to receive MQP Credit pursuant to this rule; and that termination of an MQP Company, MQP Security, or MQP Market Maker does not preclude the Exchange from allowing re-entry into the Program where the Exchange deems proper.

<sup>64</sup> Proposed Rule 5950(b)(2)(A).

<sup>65</sup> Proposed Rule 5950(b)(2)(B).

The MQP Fee is in addition to the standard (non-MQP) NASDAQ listing fee applicable to the MQP Security and does not offset such standard listing fee.<sup>66</sup> NASDAQ will bill prospectively each MQP Company for the quarterly MQP Fee for each MQP Security. MQP Fees (basic and supplemental) will be credited to the NASDAQ General Fund.<sup>67</sup>

#### Proposed Rule 5950 - MQP Credit to Market Makers

When making a market in an MQP Security, an MQP Market Maker must, in addition to fulfilling the market making obligations per Rule 4613,<sup>68</sup> meet or exceed several market quality requirements on a monthly basis to be eligible for an MQP Credit. First, for at least 25% of the time when quotes can be entered in the Regular Market Session<sup>69</sup> as averaged over the course of a month, an MQP Market Maker must maintain: a) at least 500 shares of attributable, displayed

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<sup>66</sup> Proposed Rule 5950(b)(2)(C). The MQP Fee in respect of an ETF shall be paid by the Sponsor(s) of such ETF.

<sup>67</sup> Proposed Rule 5950(b)(2)(D) and (E).

<sup>68</sup> Rule 4613 states that market making obligations applicable to NASDAQ members that are registered as Market Makers include, among other things, quotation requirements and obligations as follows: For each security in which a member is registered as a Market Maker, the member shall be willing to buy and sell such security for its own account on a continuous basis during regular market hours and shall enter and maintain a two-sided trading interest (“Two-Sided Obligation”) that is identified to the Exchange as the interest meeting the obligation and is displayed in the Exchange’s quotation montage at all times. Interest eligible to be considered as part of a Market Maker’s Two-Sided Obligation shall have a displayed quotation size of at least one normal unit of trading (or a larger multiple thereof); provided, however, that a Market Maker may augment its Two-Sided Obligation size to display limit orders priced at the same price as the Two-Sided Obligation. Unless otherwise designated, a “normal unit of trading” shall be 100 shares. After an execution against its Two-Sided Obligation, a Market Maker must ensure that additional trading interest exists in the Exchange to satisfy its Two-Sided Obligation either by immediately entering new interest to comply with this obligation to maintain continuous two-sided quotations or by identifying existing interest on the Exchange book that will satisfy this obligation.

<sup>69</sup> The term “Regular Market Session” shall have the meaning given in Rule 4120(b)(4)(D). Proposed Rule 5950(e)(6).

quotes<sup>70</sup> or orders at the NBBO or better on the bid side of an MQP Security; and b) at least 500 shares of attributable, displayed quotes or orders at the NBBO or better on the offer side of an MQP Security. And second, 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, a MQP Market Maker must maintain: a) 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 of an MQP Security; and b) 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 offer side of an MQP Security.<sup>71</sup>

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<sup>70</sup> These are quotes that are attributable to members and not hidden quotes.

<sup>71</sup> Proposed Rule 5950(c)(1)(B).

For example, regarding the first market quality standard (25%) - in an MQP Security where the NBBO is \$25.00 x \$25.10, for a minimum of 25% of the time when quotes can be entered in the Regular Market Session as averaged over the course of a month, an MQP Market Maker must maintain bids at or better than \$25.00 for at least 500 shares and must maintain offers at or better than \$25.10 for at least 500 shares. Thus, if there were 20 trading days in a given month and the MQP Market Maker met this requirement 20% of the time when quotes can be entered in the Regular Market Session for 10 trading sessions and 40% of the time when quotes can be entered in the Regular Market Session for 10 trading sessions then the MQP Market Maker would have met the requirement 30% of the time in that month.

For example, regarding the second market quality standard (90%) – in an MQP Security where the NBBO is \$25.00 x \$25.10, for a minimum of 90% of the time when quotes can be entered in the Regular Market Session as averaged over the course of a month, an MQP Market Maker must post bids for an aggregate of 2,500 shares between \$24.50 and \$25.00, and post offers for an aggregate of 2,500 shares between \$25.10 and \$25.60. Thus, if there were 20 trading days in a given month and the MQP Market Maker met this requirement 88% of the time when quotes can be entered in the Regular Market Session for 10 trading sessions and 98% of the time when quotes can be entered in the Regular Market Session for 10 trading sessions then the MQP Market Maker would have met the requirement 93% of the time in that month.

MQP Credits for each MQP Security will be calculated monthly and credited quarterly on a pro rata basis to one or more eligible MQP Market Makers<sup>72</sup> out of the Exchange's General Fund. Each MQP Credit will be allocated 50% to a Quote Share Payment that is based on Qualified Quotes, and 50% to a Trade Share Payment that is based on Qualified Trades.<sup>73</sup> Trade Share Payments will, as discussed, be based upon the total aggregate share amount of Qualified Trades in an MQP Security executed on the NASDAQ Market Center;<sup>74</sup> and Quote Share Payments will be based in equal proportions on: a) average quoted size at or better than NBBO, and b) average time spent quoting at or better than NBBO.<sup>75</sup>

An MQP Credit will be credited quarterly to an MQP Market Maker on a pro rata basis for each month during such quarter that an MQP Market Maker is eligible to receive a credit pursuant to the proposed rule. However, the calculation to establish the eligibility of an MQP Market Maker will be done on a monthly basis. Thus, for example, if during a quarter an MQP Market Maker was eligible to receive a credit for two out of three months, he would receive a quarterly pro rata MQP Credit for those two months.<sup>76</sup>

NASDAQ may limit, on a Program-wide basis, how many MQP Market Makers are permitted to register in an MQP Security, and will provide notification on its website of any such

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<sup>72</sup> NASDAQ may accept multiple MQP Market Makers into the Program. Proposed Rule 5950(c)(1)(A).

<sup>73</sup> Proposed Rule 5950(c)(2)(A). This subsection indicates that a Qualified Quote represents attributable and displayed liquidity (either quotes or orders) in an MQP Security; that a quote or order entered by an MQP Market Maker in an MQP Security is only a Qualified Quote if it is posted within 2% of the NBBO; and that a Qualified Trade in an MQP Security represents a liquidity-providing execution of a Qualified Quote on the NASDAQ Market Center.

<sup>74</sup> Proposed Rule 5950(e)(4).

<sup>75</sup> Proposed Rule 5950(c)(2)(B).

<sup>76</sup> Proposed Rule 5950(c)(2)(C).

limitation. As discussed above, if a limit is established, NASDAQ will allocate available MQP Market Maker registrations in a first-come-first-served fashion based on successful completion of an MPQ Market Maker application.<sup>77</sup>

Finally, to give the Exchange and the Commission an opportunity to evaluate the impact of the MQP on the quality of markets in MQP Securities, the Exchange is proposing that the MQP will be effective for a one year pilot period. During the pilot period, the Exchange will submit monthly reports to the Commission about market quality in respect of the MQP. The monthly reports will endeavor to compare, to the extent practicable, securities before and after they are in the MQP and will include information regarding the MQP such as: 1) Rule 605 metrics;<sup>78</sup> 2) volume metrics; 3) number of MQP Market Makers in target securities; 4) spread size; and 5) availability of shares at the NBBO. The Exchange will endeavor to provide similar data to the Commission about comparable ETFs that are listed on the Exchange that are not in the MQP; and any other MQP-related data requested by the Commission for the purpose of evaluating the efficacy of the MQP. The Exchange will post the monthly reports on its website.

The first report will be submitted within sixty days after the MQP becomes operative.

The Exchange will issue to its members an information bulletin about the MQP prior to operation of the Program.

#### Surveillance

The Exchange believes that its surveillance procedures are adequate to properly monitor the trading of targeted securities (including ETFs) on the Exchange during all trading sessions, and to detect and deter violations of Exchange rules and applicable federal securities laws.

Trading of the targeted MQP Securities through the Exchange will be subject to FINRA's

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<sup>77</sup> Proposed Rule 5950(c)(3). See also supra note 57.

<sup>78</sup> 17 CFR 242.605.

surveillance procedures for derivative products including ETFs.<sup>79</sup> The Exchange may obtain information via the Intermarket Surveillance Group (“ISG”) from other exchanges that are members or affiliates of the ISG;<sup>80</sup> and from listed MQP Companies and public and non-public data sources such as, for example, Bloomberg.

## 2. Statutory Basis

NASDAQ believes that the proposed rule change is consistent with the provisions of Section 6 of the Act,<sup>81</sup> in general, and with Sections 6(b)(4) and 6(b)(5) of the Act,<sup>82</sup> in particular, 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.

The goal of the MQP - 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. Congress instructed the Commission to pursue this goal by emphasizing multiple policies, including the promotion of price discovery, order interaction and competition among orders and markets. The MQP promotes all of these policies; it will enhance quote competition, improve NASDAQ liquidity, support the quality of price discovery, promote market transparency and increase competition for listings and trade executions while reducing spreads and transaction costs. Maintaining and increasing liquidity in exchange-listed securities

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<sup>79</sup> FINRA surveils trading on the Exchange pursuant to a Regulatory Services Agreement (“RSA”). The Exchange is responsible for FINRA’s performance under this RSA.

<sup>80</sup> For a list of the current members and affiliate members of ISG, see [www.isgportal.com](http://www.isgportal.com).

<sup>81</sup> 15 U.S.C. 78f.

<sup>82</sup> 15 U.S.C. 78f(b)(4) and (5).

executed on a registered exchange will help raise investors' confidence in the fairness of the market and their transactions. Improving liquidity in this manner is particularly important with respect to ETFs and low-volume securities, as noted by the Joint CFTC/SEC Advisory Commission on Emerging Regulatory Issues.<sup>83</sup>

Each aspect of the MQP adheres to and supports the Act. First, the Program promotes the equitable allocation of fees and dues among issuers. The MQP is completely voluntary in that it will provide an additional means by which issuers may relate to the Exchange without modifying the existing listing options. Issuers can supplement the standard listing fees (which have already been determined to be consistent with the Act) with those of the MQP (which are consistent with the Act as well). While the MQP will result in higher fees for issuers that choose to participate, the issuers receive significant benefits for participating, including greater liquidity, and lower transaction costs for their investors. Additionally, issuers will have the ability to withdraw from the Program after an initial commitment in the event they determine that participation is not beneficial. In that case, the withdrawing issuers will automatically revert to the already-approved fee schedule applicable to the market tier in which their shares are listed.

The MQP also represents an equitable allocation of fees and dues among Market Makers. Again, the MQP is completely voluntary with respect to Market Maker participation in that it will provide an additional means by which members may qualify for a credit, without eliminating any of the existing means of qualifying for incentives on the Exchange. Currently, NASDAQ and other exchanges use multiple fee arrangements to incentivize Market Makers to

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<sup>83</sup> See Recommendations Regarding Regulatory Responses To The Market Events Of May 6, 2010, February 18, 2011 (Recommendation that the SEC evaluate whether incentives or regulations can be developed to encourage persons who engage in market making strategies to regularly provide buy and sell quotations that are “reasonably related to the market.”). Available at <http://www.sec.gov/spotlight/sec-cftcjointcommittee/021811-report.pdf>.

maintain high quality markets or to improve the quality of executions, including various payment for order flow arrangements, liquidity provider credits, and NASDAQ's Investor Support Program (set forth in NASDAQ Rule 7014). Market Makers that choose to undertake increased burdens pursuant to the MQP will be rewarded with increased credits; those that do not undertake such burdens will receive no added benefit. As with issuers, Market Makers that choose to participate in the MQP will be permitted to withdraw from it after an initial commitment if they determine that the burdens imposed by the MQP outweigh the benefits provided.

Additionally, the MQP establishes an equitable allocation of MQP Credits among Market Makers that choose to participate and fulfill the obligations imposed by the rule. If one Market Maker fulfills those obligations, the MQP Credit will be distributed by NASDAQ to that Market Maker out of the General Fund; and if multiple Market Makers satisfy the standard, the MQP Credit will be distributed pro rata among them. In other words, all of the benefit of the MQP Credits will flow to high-performing Market Makers, provided that at least one Market Maker fulfills the obligations under the proposed rule.

The MQP is designed to avoid unfair discrimination among Market Makers and issuers. The proposed rule contains objective, measurable (universal) standards that NASDAQ will apply with care. These standards will be applied equally to ensure that similarly situated parties are treated similarly. This is equally true for inclusion of issuers and Market Makers, withdrawal of issuers and Market Makers, and termination of eligibility for the MQP. The standards are carefully constructed to protect the rights of all parties wishing to participate in the Program by providing notice of requirements and a description of the selection process. NASDAQ will



apply these standards with the same care and experience with which it applies the many similar rules and standards in NASDAQ's rule manuals.

In contrast to the extensive benefits of the MQP, the participation of an MQP Company in the Program is substantially limited by design. In this regard, an MQP Company is limited to making only the following determinations regarding the Program: whether to participate in the Program; what MQP Security should be in the Program; when the MQP Security should exit the Program; and the level of Supplemental Fees, if any, that should be applied. The MQP Company can never choose an MQP Market Maker, nor influence how, when, or the specific amount that an MQP Market Maker receives as credit for making a market in an MQP Security; these functions are performed solely by the Exchange according to standards set forth in the Program.<sup>84</sup>

NASDAQ notes that it operates in a highly competitive market in which market participants can readily favor competing venues if they deem fee levels at a particular venue to be excessive, or rebate opportunities available at other venues to be more favorable. In such an environment, NASDAQ must continually adjust its fees and program offerings to remain competitive with other exchanges and with alternative trading systems that have been exempted from compliance with the statutory standards applicable to exchanges. NASDAQ believes that all aspects of the proposed rule change reflect this competitive environment because the MQP is designed to increase the credits provided to members that enhance NASDAQ's market quality.

Finally, NASDAQ notes that the proposed paid for market making system has been used successfully for years on NASDAQ OMX Nordic's First North market. The First North paid for

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<sup>84</sup> Indeed, the Exchange will not pay an MQP Market Maker pursuant to the Program for making a market in an MQP Security; rather, the Exchange will pay an incentive out of its General Fund if - and only if - an MQP Market Maker achieves very specific, rules-based market quality objectives when otherwise making a market.

market making system has been quite beneficial to market participants including investors and listing companies (issuers) that have experienced market quality and liquidity with narrowed spreads. The Exchange believes that the proposed MQP will similarly enjoy positive results to the benefit of investors in MQP Securities and Companies related to them and the financial markets as a whole.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASDAQ does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended. To the contrary, NASDAQ believes the MQP program is pro-competitive in that it will increase competition in both the listings market and in the transaction services market. The MQP will promote competition in the listings market by advancing NASDAQ's reputation as an exchange that works tirelessly to develop a better market for all issuers, and for partnering with issuers to improve the quality of trading on NASDAQ. In fact, the MQP is itself a response to the competition provided by other markets that are developing similar programs, including NYSE Arca and BATS. NASDAQ fully expects that other listing venues will respond to the MQP by further enhancing their listings market offerings.

The MQP promotes competition in the transaction services market by creating incentives for market makers to make better quality markets. As market makers strive to attain the quality standards established by the MQP, the quality of NASDAQ's quotes will improve. This, in turn, will attract more liquidity to NASDAQ and further improve the quality of trading of MQP stocks. Again, if the MQP is successful in its goals, NASDAQ fully expects that competing markets will respond by creating incentives of their own to improve the quality of their markets and to attract liquidity to their markets.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission shall: (a) by order approve or disapprove such proposed rule change, or (b) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. The Commission previously received comments on SR-NASDAQ-2012-043, which proposed rule change was withdrawn by the Exchange,<sup>85</sup> and all such comments are available on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>).

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASDAQ-2012-137 on the subject line.

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<sup>85</sup> See supra note 3.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2012-137. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Section, 100 F Street, NE, Washington, DC 20549-1090, on official business days between 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information

that you wish to make available publicly. All submissions should refer to File Number SR-NASDAQ-2012-137 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>86</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>86</sup> 17 CFR 200.30-3(a)(12).