

## SECURITIES AND EXCHANGE COMMISSION

Release No. 34-69196

March 20, 2013

### Order Granting a Limited Exemption from Rule 102 of Regulation M Concerning the NASDAQ Stock Market LLC Market Quality Program Pilot Pursuant to Regulation M Rule 102(e)

The Securities and Exchange Commission (“Commission”) approved a proposed rule change of the NASDAQ Stock Market LLC (“Exchange” or “NASDAQ”) to add new NASDAQ Rule 5950 (“New Rule 5950”) to establish the Market Quality Program (“MQP” or “Program”).<sup>1</sup>

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<sup>1</sup> Securities Exchange Act Release No. 69195, (Mar. 20, 2013) (“Approval Order”). The Approval Order contains a detailed description of the MQP. On December 7, 2012, NASDAQ filed with the Commission, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, as amended (“Act” or “Exchange Act”) and Rule 19b-4 thereunder, a proposed rule change to establish the MQP. The proposed rule change, as modified by Amendment No. 1 thereto, was published for comment in the Federal Register on December 31, 2012. Securities Exchange Act Release No. 68515 (Dec. 21, 2012), 77 FR 77141 (Dec. 31, 2012) (“Notice”). On February 7, 2013, NASDAQ submitted Amendment No. 2 to the proposed rule change. On February 8, 2013, NASDAQ withdrew Amendment No. 2 due to a technical error in that amendment and submitted Amendment No. 3 to the proposed rule change. As noted in the Approval Order, Amendment No. 3 provided clarification to the proposed rule change and did not require notice and comment. On February 14, 2013, the Commission designated a longer period within which to take action on the proposed rule change. Securities Exchange Act Release No. 68925 (Feb. 14, 2013), 78 FR 12116 (Feb. 21, 2013). The Approval Order grants approval of the proposed rule change, as modified by Amendment Nos. 1 and 3.

Previously, NASDAQ filed, but later withdrew, an initial proposed rule change to establish the MQP. On March 23, 2012, NASDAQ filed with the Commission, pursuant to Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder, a proposed rule change to establish the MQP. On March 29, 2012, the Exchange submitted Amendment No. 1 to the proposed rule change. The proposed rule change, as modified by Amendment No. 1 thereto, was published for comment in the Federal Register on April 12, 2012. Securities Exchange Act Release No. 66765 (Apr. 6, 2012), 77 FR 22042 (Apr. 12, 2012). On May 18, 2012, the Commission extended the time period in which to either approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change to July 11, 2012. Securities Exchange Act Release No. 67022 (May 18, 2012), 77 FR 31050 (May 24, 2012). On July 11, 2012, the Commission instituted proceedings to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1. Securities Exchange Act Release No. 67411 (Jul. 11, 2012), 77 FR 42052 (Jul. 17, 2012). On October 2, 2012, the Commission issued a notice of designation of a longer period for Commission action on proceedings to determine whether to disapprove the proposed rule change. Securities Exchange

In connection with the Program, an MQP Company<sup>2</sup> may list an eligible MQP Security<sup>3</sup> on NASDAQ and in addition to the standard (non-MQP) NASDAQ listing fee, a sponsor may pay a fee (“MQP Fee”)<sup>4</sup> that will be used for the purpose of incentivizing one or more market makers to enhance the market quality of an MQP Security on a voluntary pilot basis. The Commission believes that payment of the MQP Fee, which is incurred by the MQP Company but paid by the sponsor associated with the MQP Company, for the purpose of incentivizing market makers to make a quality market in otherwise less liquid MQP Securities would constitute an indirect attempt by the issuer to induce a bid for or a purchase of a covered security during a restricted period.<sup>5</sup> As a result, absent exemptive relief, participation in the MQP by an MQP Company would violate Rule 102 of Regulation M.<sup>6</sup> This order grants a limited exemption from Rule 102

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Act Release No. 67961, 77 FR 61452 (Oct. 9, 2012). On November 6, 2012, NASDAQ submitted Amendment No. 2 to the proposed rule change. On December 6, 2012, NASDAQ withdrew the proposed rule change, as modified by Amendment Nos. 1 and 2 thereto. Securities Exchange Act Release No. 68378, 77 FR 74042 (Dec. 12, 2012) (Securities Exchange Act Release Nos. 66765, 67022, 67411, 67961, and 68378 collectively, the “Initial Proposal”).

<sup>2</sup> The term “MQP Company” means the trust or company housing the exchange traded fund (“ETF”) or, if the ETF is not a series of a trust or company, then the ETF itself. New Rule 5950(e)(5).

<sup>3</sup> The term “MQP Security” means an ETF security issued by an MQP Company that meets all of the requirements to be listed on NASDAQ pursuant to Rule 5705. New Rule 5950(e)(1).

<sup>4</sup> The MQP Fee, as described more fully in New Rule 5950(b)(2), consists of an annual basic MQP Fee, and may include an additional annual supplemental fee.

<sup>5</sup> See Securities Exchange Act Release No. 67411 (Jul. 11, 2012), 77 FR 42052 (Jul. 17, 2012) (stating “The Commission believes that issuer payments made under the SRO Proposals would constitute an indirect attempt by the issuer of a covered security to induce a purchase or bid in a covered security during a restricted period in violation of Rule 102 ... [u]nder the NASDAQ Proposal, the issuer payments would ‘be used for the purpose of incentivizing one or more Market Makers in the MQP Security,’ which could induce bids or purchases for the issuer’s security during a restricted period”).

<sup>6</sup> 17 CFR 242.102.

of Regulation M solely to permit MQP Companies to participate in the MQP during the pilot, subject to certain conditions described below.

NASDAQ represents that the MQP is designed to “promote market quality” in certain ETFs listed on NASDAQ.<sup>7</sup> NASDAQ represents that, pursuant to the MQP, the MQP Fee will be used for the purpose of incentivizing one or more market makers in the MQP Security (“MQP Market Maker”)<sup>8</sup> to make a quality market in the MQP Security.<sup>9</sup> An MQP Company participating in the MQP shall incur an annual basic MQP Fee of \$50,000 per MQP Security.<sup>10</sup> An MQP Company may also voluntarily incur an annual supplemental MQP Fee per MQP Security.<sup>11</sup> The MQP Fee is in addition to the standard (non-MQP) NASDAQ listing fee applicable to the MQP Security.<sup>12</sup> NASDAQ will prospectively bill each MQP Company for the MQP Fee.<sup>13</sup> The MQP Fee will be credited to the NASDAQ General Fund.<sup>14</sup> MQP Credits for each MQP Security will be calculated monthly and credited out of the NASDAQ General Fund

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<sup>7</sup> New Rule 5950 Preamble.

<sup>8</sup> “The term ‘Market Maker’ has the meaning given in Rule 5005(a)(24).” New Rule 5950(e)(3).

<sup>9</sup> New Rule 5950 Preamble.

<sup>10</sup> New Rule 5950(b)(2)(A).

<sup>11</sup> New Rule 5950(b)(2)(B).

<sup>12</sup> New Rule 5950(b)(2)(C).

<sup>13</sup> New Rule 5950(b)(2)(D).

<sup>14</sup> New Rule 5950(b)(2)(E).

quarterly on a pro rata basis to one or more eligible MQP Market Makers.<sup>15</sup> The voluntary MQP established by New Rule 5950 will be effective on a pilot basis.<sup>16</sup>

Under New Rule 5950, NASDAQ will be required to provide notification on its website regarding: (i) acceptance of an MQP Company, on behalf of an MQP Security, and an MQP Market Maker into the Program;<sup>17</sup> (ii) the total number of MQP Securities that any one MQP Company may have in the Program;<sup>18</sup> (iii) the names of MQP Securities and MQP Market Maker(s) in each 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>19</sup> (iv) a statement about the MQP that sets forth 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;<sup>20</sup> (v) when NASDAQ receives notification that an MQP Company, on behalf of an MQP Security, or a Market Maker intends to withdraw from the Program, and the date of actual withdrawal or

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<sup>15</sup> New Rule 5950(c)(2).

<sup>16</sup> New Rule 5950(f).

<sup>17</sup> New Rule 5950(a)(1)(C)(i).

<sup>18</sup> New Rule 5950(a)(1)(C)(ii).

<sup>19</sup> New Rule 5950(a)(1)(C)(iii).

<sup>20</sup> New Rule 5950(a)(1)(C)(iv).

termination from the Program;<sup>21</sup> and (vi) any limit on the number of MQP Market Makers permitted to register in an MQP Security.<sup>22</sup> Furthermore, MQP Companies must, on a product-specific website for each product, indicate that the product is in the MQP and provide a link to the Exchange’s MQP webpage during such time that the MQP Company lists an MQP Security.<sup>23</sup>

In response to the Notice, the Commission received three comment letters in support of the MQP.<sup>24</sup> One commenter stated that the MQP program “could create value for an issuer,” “jump-start trading,” and make future liquidity “less uncertain.”<sup>25</sup> One commenter believes “the MQP could benefit promising tech companies that today may lack liquid, quality markets.”<sup>26</sup> Another commenter stated that “payments from issuers to market makers are used in a number of countries outside of the United States with great success.”<sup>27</sup> This commenter reiterated answers to questions concerning disclosure posed in connection with the Initial Proposal. In some areas, the commenter stated that “more information is probably better than less,” but in other areas

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<sup>21</sup> New Rule 5950(a)(2)(D).

<sup>22</sup> New Rule 5950(c)(3).

<sup>23</sup> New Rule 5950(b)(1)(D).

<sup>24</sup> Letter from Albert J. Menkveld, Associate Professor of Finance, VU University Amsterdam and the Duisenberg School of Finance, dated February 18, 2013 (“Menkveld Letter”), Letter from Rey Ramsey, President and CEO, TechNet, dated January 22, 2013 (“TechNet Letter”) and Letter from Daniel G. Weaver, Ph.D., Professor of Finance, Rutgers Business School, dated January 30, 2013 (“Weaver Letter”). Both commenters submitted letters in support of the Initial Proposal as well. Letter from Rey Ramsey, President and CEO, TechNet, dated June 20, 2012 and Letter from Daniel G. Weaver, Ph.D., Professor of Finance, Rutgers Business School, dated April 26, 2012.

<sup>25</sup> Menkveld Letter.

<sup>26</sup> TechNet Letter.

<sup>27</sup> Weaver Letter.

cautioned about the “potential for information overload.”<sup>28</sup> Further, the commenter stated that a ticker symbol identifier could be used in connection with an MQP Company’s participation in the Program to signal to investors that lower volatility is generated by the Program.<sup>29</sup> Another commenter agreed that “MQP brokers’ trades and quotes should be flagged.”<sup>30</sup>

In addition, commenters generally in favor of the Initial Proposal supported the Program’s stated goal to increase liquidity and promote efficient, robust markets for exchange-traded products.<sup>31</sup> However, in connection with the Initial Proposal, certain commenters expressed concerns about the MQP, including the departure from rules precluding market makers from directly or indirectly accepting payment from an issuer of a security for acting as a market maker.<sup>32</sup> In particular, commenters discussed the potential distortive impact on the natural

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<sup>28</sup> Id.

<sup>29</sup> Id.

<sup>30</sup> Menkveld Letter.

<sup>31</sup> See, e.g., Letter from Joseph Cavatoni, Managing Director, and Joanne Medero, Managing Director, BlackRock, Inc., dated July 11, 2012.

<sup>32</sup> See, e.g., Letter from Gus Sauter, Managing Director and Chief Investment Officer, Vanguard, dated May 3, 2012 (citing to a discussion in NASD Notice to Members 75-16 regarding the reasons for prohibiting issuer payments for market making: “The additional factor of payments by an issuer to a market maker would probably be viewed as a conflict of interest since it would undoubtedly influence, to some degree, a firm’s decision to make a market and thereafter, perhaps, the prices it would quote. Hence, what might appear to be independent trading activity may well be illusory.”). In addition, another commenter noted “that the MQP would represent a departure from the current rules precluding market makers from directly or indirectly accepting payment from an issuer of a security for acting as a market marker” yet supported the concept of market maker incentive programs on a pilot basis. Letter from Ari Burstein, Investment Company Institute (“ICI”), dated May 3, 2012. In a subsequent letter, however, the same commenter noted that certain of its members opposed the MQP and stated that it “could create a ‘pay-to-play’ environment.” Letter from Ari Burstein, ICI, dated August 16, 2012. Pursuant to the Approval Order, the Exchange will adopt new IM-2460-1 to exclude the MQP from NASDAQ Rule 2460 (Payment for Market Making). The Approval Order notes that NASDAQ Rule 2460 is almost identical to, and is based on, FINRA Rule 5250 (Payments for Market Making) and that a number of aspects of the MQP mitigate the concerns that FINRA Rule 5250 and NASDAQ Rule 2460 were designed to address.

market forces of supply and demand.<sup>33</sup> Commenters also discussed what they viewed as the failure of Program requirements to adequately mitigate potential negative impacts of the MQP, including concerns about hampering investors' ability to evaluate quotations in MQP Securities.<sup>34</sup>

One commenter stated that “[i]ssuer payments to market makers have the potential to distort market forces, resulting in spreads and prices that do not reflect actual supply and demand.”<sup>35</sup> Another commenter suggested that “[i]ncentivized trading obfuscates true supply and demand by creating volume where no natural buyers and sellers exist.”<sup>36</sup> One commenter questioned whether any safeguards could alleviate their concerns regarding issuer payments to market makers.<sup>37</sup> Another commenter questioned whether information that would be posted to NASDAQ’s website would adequately address investor protection and market integrity concerns because investors may not search the NASDAQ website for important information about a particular product.<sup>38</sup>

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<sup>33</sup> See, e.g., Letter from F. William McNabb, Chairman and Chief Executive Officer, Vanguard, dated August 16, 2012.

<sup>34</sup> See, e.g., Letter from Gus Sauter, Managing Director and Chief Investment Officer, Vanguard, dated May 3, 2012.

<sup>35</sup> Letter from F. William McNabb, Chairman and Chief Executive Officer, Vanguard, dated August 16, 2012.

<sup>36</sup> Letter from Timothy Quast, Managing Director, Modern IR, dated April 26, 2012.

<sup>37</sup> Letter from Ari Burstein, ICI, dated August 16, 2012 (stating “ICI members who oppose the Programs believe any fixes to the proposed parameters will be insufficient to address their overall concerns with market maker incentive programs”).

<sup>38</sup> Letter from Gus Sauter, Managing Director and Chief Investment Officer, Vanguard, dated May 3, 2012 (asking “[f]or example, given what we know about investor behavior, is it likely that investors would consult Nasdaq’s website for information about which ETFs and market makers are participating in the Program... [i]f not, then most investors would not be able to distinguish

## **Rule 102 of Regulation M**

Rule 102 of Regulation M prohibits issuers, selling security holders, or any affiliated purchaser of such persons, directly or indirectly, from bidding for, purchasing, or attempting to induce any person to bid for or purchase a covered security<sup>39</sup> during the applicable restricted period in connection with a distribution of securities effected by or on behalf of an issuer or selling security holder, except as specifically permitted in the rule.<sup>40</sup> As mentioned above, the Commission believes that the payment of the MQP Fee would constitute an indirect attempt to induce a bid for or purchase of a covered security during the applicable restricted period.<sup>41</sup> As a result, absent exemptive relief, participation in the MQP by an MQP Company would violate Rule 102.

On the basis of the conditions set out below and the requirements set forth in New Rule 5950, which in general are designed to help inform investors about the potential impact of the MQP, the Commission finds that it is appropriate in the public interest, and is consistent with the protection of investors, to grant a limited exemption from Rule 102 of Regulation M solely to permit the payment of the MQP Fee as set forth in New Rule 5950 during the pilot.<sup>42</sup> This

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quotations that reflect true market forces from quotations that have been influenced by issuer payments”). As discussed below, while New Rule 5950 requires certain disclosures on the NASDAQ website, the Commission believes that additional disclosures are required to address these concerns as they relate to relief from Rule 102 of Regulation M.

<sup>39</sup> Covered security is defined as any security that is the subject of a distribution, or any reference security. 17 CFR 242.100(b).

<sup>40</sup> 17 CFR 242.102(a).

<sup>41</sup> See note 5, supra.

<sup>42</sup> Rule 102(e) allows the Commission to grant an exemption from the provision of Rule 102, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities.

limited exemption is conditioned on a requirement that the MQP Security is an ETF and the secondary market price for shares of the ETF must not vary substantially from the net asset value of such ETF shares during the duration of the ETF's participation in the MQP. This condition is designed to limit the MQP to ETFs that have a pricing mechanism that is expected to keep the price of the ETF shares tracking the net asset value of the ETF shares, which should make the shares less susceptible to price manipulation.

This limited exemption is further conditioned on disclosure requirements, as set forth below, which are designed to alert potential investors that the trading market for the otherwise less liquid securities in the MQP may be affected by the Program. By making it easier for investors to be able to distinguish which quotations may have been influenced by the MQP Fee from those that have not, and by requiring the MQP Companies to provide information on the potential effect of Program participation on the price of their MQP Securities, the required enhanced disclosure requirements are designed to inform potential investors about the potential distortive impact of the MQP Fee on the natural market forces of supply and demand. General disclosure provided on the Exchange's website and a simple notification on a product-specific website, as required under new NASDAQ Rule 5950, may not be sufficient to obtain this result. The required enhanced disclosures are expected to promote greater investor protection by helping to ensure that investors (who may not know to search the NASDAQ's website) will have easier access to important information about a particular ETF.<sup>43</sup> We also note that, to the extent that information about participation in the MQP is material, disclosure of this kind may already be required by the federal securities laws and rules.

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<sup>43</sup> The required website and press release disclosures should be less burdensome than requiring a ticker symbol identifier or flagging MQP broker quotes and trades, as suggested by two commenters.

## Conclusion

IT IS THEREFORE ORDERED, that MQP Companies are hereby exempted from Rule 102 of Regulation M solely to permit the payment of the MQP Fee as set forth in New Rule 5950 in connection with an MQP Security during the pilot, subject to the conditions contained in this order and compliance with the requirements of New Rule 5950.

This exemption is subject to the following conditions:

1. The MQP Security is an ETF and the secondary market price for shares of the ETF must not vary substantially from the net asset value of such ETF shares during the duration of the MQP Security's participation in the MQP;
2. An MQP Company must provide prompt notice to the public by broadly disseminating a press release prior to entry (or upon re-entry) into the MQP. This press release must disclose:
  - a. The payment of an MQP Fee is intended to generate more quotes and trading than might otherwise exist absent this payment, and that the MQP Security leaving the Program may adversely impact a purchaser's subsequent sale of the security; and
  - b. A hyperlink to the webpage described in condition (4) below;
3. An MQP Company must provide prompt notice to the public by broadly disseminating a press release prior to an MQP Security leaving the Program for any reason, including termination of the Program. This press release must disclose:
  - a. The date that the MQP Security is leaving the MQP and that leaving the MQP may have a negative impact on the price and liquidity of the MQP Security

which could adversely impact a purchaser's subsequent sale of the MQP Security; and

- b. A hyperlink to the webpage described in condition (4) below;
4. An MQP Company must provide prompt, prominent and continuous disclosure on its website in the location generally used to communicate information to investors about a particular MQP Security, and for an MQP Security that has a separate website, the MQP Security's website of:
    - a. The MQP Security and ticker, date of entry into the Program, and the amount of the MQP Fee (basic and supplemental, if any);
    - b. Risk factors investors should consider when making an investment decision, including that participation in the Program may have potential impacts on the price and liquidity of the MQP Security; and
    - c. Termination date of the pilot, anticipated date (if any) of the MQP Security leaving the Program for any reason and the date of actual exit date (if applicable), and that the MQP Security leaving the Program could adversely impact a purchaser's subsequent sale of the MQP Security; and
  5. The website disclosure in condition 4 must be promptly updated if a material change occurs with respect to any information contained in the disclosure.

This exemptive relief expires when the pilot terminates, and is subject to modification or revocation at any time the Commission determines that such action is necessary or appropriate in furtherance of the purposes of the Exchange Act. This exemptive relief is limited solely to the payment of the MQP Fee as set forth in New Rule 5950 for an MQP Security that is an ETF participating in the Program, and does not extend to any other activities, any other security of the

MQP Company, or any other issuers.<sup>44</sup> In addition, persons relying on this exemption are directed to the anti-fraud and anti-manipulation provisions of the Exchange Act, particularly Sections 9(a) and 10(b), and Rule 10b-5 thereunder. Responsibility for compliance with these and any other applicable provisions of the federal securities laws must rest with the persons relying on this exemption. This order does not represent Commission views with respect to any other question that the proposed activities may raise, including, but not limited to the adequacy of the disclosure required by federal securities laws and rules, and the applicability of other federal or state laws and rules to, the proposed activities.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>45</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>44</sup> Other activities, such as ETF redemptions, are not covered by this exemptive relief.

<sup>45</sup> 17 CFR 200.30-3(a)(6).