

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-66765; File No. SR-NASDAQ-2012-043)

April 6, 2012

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

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on March 23, 2012, The NASDAQ Stock Market LLC (“NASDAQ”) 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 substantially prepared by NASDAQ. On March 29, 2012, the Exchange submitted Amendment No. 1 to the proposed rule change.³ 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 (also known as the “Exchange”) 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 voluntary program will benefit investors, issuers or

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ In Amendment No. 1, the Exchange made a technical amendment to Item I of Exhibit 1 to delete an erroneous reference to the NASDAQ Options Market and replace it with a reference to the Exchange.

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, on the Commission's website at www.sec.gov, 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

The purpose of the filing is to propose new Rule 5950 to enable Market Makers⁴ 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")

⁴ 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. Proposed Rule 5950(e)(5).

or “Program”), and to exempt the Program from Rule 2460.

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 Company⁵ and one or more related Market Makers are accepted into the MQP in respect of a security listed pursuant to the Program (“MQP Security”).⁶ The pilot program will end one year after implementation.⁷ During the pilot, the Exchange will periodically provide information to the

⁵ The term “MQP Company” is defined in proposed Rule 5950(e)(7) as a fund (Exchange Traded Fund) sponsor or other entity that lists one or more MQP Securities on NASDAQ pursuant to the Market Quality Program. The term “Company” is defined in Rule 5005(a)(6) as the issuer of a security listed or applying to list on NASDAQ, and may include an issuer that is not incorporated, such as, for example, a limited partnership.

⁶ The term “MQP Security” is defined in proposed Rule 5950(e)(1) as a security that meets all of the requirements to be listed on NASDAQ as an Exchange Traded Fund, Linked Security, or Trust Issued Receipt pursuant to Rules 5705, 5710, or 5720, respectively.

⁷ 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) (“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.

Commission about market quality in respect of the MQP.

MQP Securities may include Exchange Traded Funds (“ETFs”), Linked Securities (“LS”), and Trust Issued Receipts (“TIRs”).⁸ However, the Exchange believes that MQP Securities will predominantly, if not entirely, consist of ETFs as reflected in the proposal.

Background

The proposed Market Quality Program is a voluntary program designed to promote market quality in MQP Securities.⁹ An MQP Company that lists an eligible MQP Security on NASDAQ will pay a listing fee as set forth in proposed Rule 5950 (“MQP Fee”) in addition to the standard (non-MQP) NASDAQ listing fee applicable to such MQP Security as set forth in the Rule 5000 Series (consisting of Rules 5000 - 5999).¹⁰ An MQP Fee will be used for the purpose of incentivizing 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, this incentive will be credited (“MQP Credit”) to one or more MQP Market Makers

⁸ For definitions of ETF, LS, and TIR, see proposed Rule 5950 subsections (e)(2), (e)(3), and (e)(4), respectively.

⁹ The Exchange notes that MQP Securities do not encompass derivatives on such securities.

¹⁰ The Rule 5000 Series contains rules related to the qualification, listing, and delisting of Companies on the NASDAQ Stock Market. 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 the NASDAQ Stock Market, 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.

that make a quality market in the MQP Security pursuant to the Program.¹¹

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 Exchange proposes the MQP to 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 of securities of less well known or start-up companies as components.¹² Second, in rewarding Market Makers that are willing to “go the extra mile” to

¹¹ 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.

¹² 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.

The Exchange expects, as noted, that MQP Securities will largely or entirely consist of ETFs, and discusses them accordingly in the proposal. The Exchange notes that the MQP is available and appropriate for LS and TIR products, which have some characteristics in common with ETF products. For example, TIRs are non-equity securities that are issued by a trust, and LS are non-equity securities that are linked to the performance of other assets, namely indexes and commodities (including currencies). See Rules 5710 and 5720.

develop liquid markets for MQP Securities,¹³ 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.”¹⁴

¹³ 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).

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

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.

In a similar vein, Robert Greifeld, Chief Executive Officer of NASDAQ, recently noted that unlike the United States, “[t]he U.K., Canada, and Sweden all have exchange markets that serve as ‘incubators’ for smaller companies.”¹⁵ 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.¹⁶ The MQP would reward Market Makers for committing capital to securities and meeting rigorous market quality benchmarks established by the Program.¹⁷ 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 2011.¹⁸ Skjeltorp and Odegaard examined paid for market making on the Oslo Stock Exchange,

¹⁵ See Robert Greifeld, CEO, NASDAQ OMX Group, 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 SEC, 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.

¹⁶ 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).

¹⁷ 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.

¹⁸ 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

which uses a market making model that is similar to that of NASDAQ's First North market,¹⁹ 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.²⁰ 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."²¹ 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 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

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.

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

²⁰ 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.

²¹ At the time of the study, SSE was owned by OMX AB. SSE merged into NASDAQ OMX in 2005 and retained its identity within the new corporate structure. The SSE paid for market making system matured into the current First North market.

significant increase in average trade size, suggesting that traders did not find it necessary to break up their orders to accommodate low market depth, and 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 Group, described the positive impact of paid for market making in the First North market, stating that NASDAQ OMX has had “great success” in increasing liquidity in stocks on First North, a European venue for smaller companies that has a program enabling companies to compensate market makers.²² Mr. Noll noted that in just five years, First North market has grown to 141 listings with a total capitalization of 2.8 billion Euros, and that 22 of the First North companies have graduated to the main market since 2006.²³

Paid for Market Making on the First North Market

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

By way of background, the First North market is an alternative listing market to the NASDAQ OMX Nordic Main Market (“Main Market”).²⁵ Both First North and Main Market

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

²³ 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.

²⁴ See supra notes 18, 19, and 20.

²⁵ NASDAQ OMX Nordic, which has securities exchanges and clearing operations in the Nordic countries Sweden, Denmark, Iceland, and Finland and Baltic countries Latvia and

are subject to and regulated by European Union (“EU”) directives²⁶ and exchange rules, and are supervised and regulated by one or more Financial Services Authorities (“FSAs”).²⁷ 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 systems that are similar to those 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.²⁸

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 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

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).

²⁶ 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.

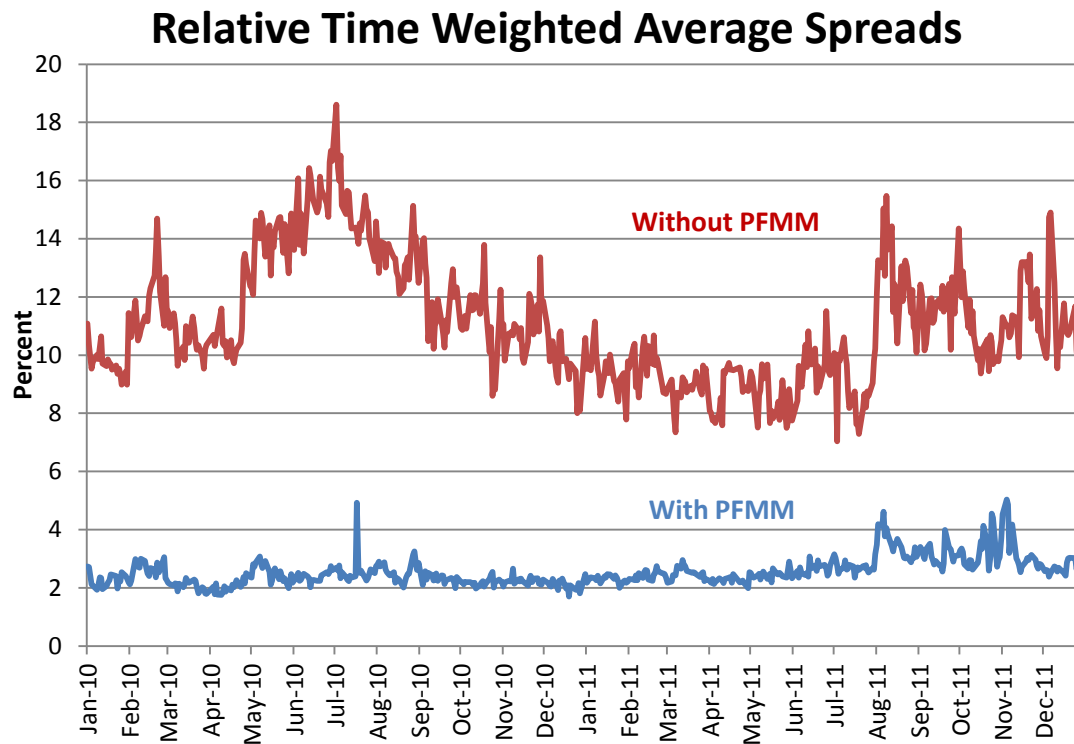
²⁷ A Financial Services Authority is the regulator of financial services and securities exchanges in an EU country (including the Nordics) and as such is similar to the Commission in respect of involvement in market regulation and oversight.

²⁸ 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.

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”)²⁹ 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 stock with PFMM were more stable through time.

²⁹ 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.³⁰ This directly benefits investors in PFMM securities by lowering their transaction costs.³¹

In terms of regulation, the First North PFMM experience has not raised concerns. Based

³⁰ 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.

³¹ 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, e.g., 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.

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.³²

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

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, promoting market transparency, and improving investor protection.³⁴

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

³² 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.

³³ 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).

³⁴ 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, e.g., Securities Exchange Act Release No. 63270 (November 8, 2010), 75 FR 69489 (November 12, 2010) (NASDAQ-2010-141) (notice of filing and immediate effectiveness of proposal to establish Investor Support Program in respect of retail or natural order flow).

investment communities, as reflected in their popularity as investment vehicles both in the U.S. and abroad.³⁵ 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.³⁶ 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.³⁷ This means that the markets are deeper and more liquid,

³⁵ 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) 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 Investment Company Act of 1940 ("1940 Act"), this is not permitted.

³⁶ 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.

³⁷ See Testimony of Eric Noll, Executive Vice President and Head of Transaction Services 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 fewer components) may choose to invest directly in the fund components after a positive ETF market quality and execution experience.

benefiting not only investors but the economy as a whole.³⁸ This proposal will allow ETFs that may not otherwise see much trading or volume³⁹ to be listed and traded on the Exchange in more liquid markets.⁴⁰

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

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

³⁹ There are a record 291 funds (216 ETFs and 75 ETNs) on the March 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.”

⁴⁰ 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 indicates that an MQP Security will no longer be eligible to remain in the MQP if the security sustains an average NASDAQ daily trading volume (“ATV”) of two million shares or more for three consecutive months. Subsection (d) also provides other reasons for termination of the MQP with respect to an MQP security: an MQP Company withdraws from the MQP, is no longer eligible to be in the MQP, or ceases to make MQP payments to NASDAQ; an MQP Security is delisted or is no longer eligible for the MQP; an MQP Security does not have at least one MQP Market Maker for more than one quarter; or an MQP Security does not, for two consecutive quarters, have at least one MQP Market Maker that is eligible for MQP Credit. Any 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 the MQP Security and were eligible to receive MQP Credit pursuant to this rule. If no MQP Market Makers qualify, then the remaining MQP Credit will be refunded to the MQP Company. 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. Proposed Rule 5950(d).

to the MQP.⁴¹ Specifically, the Exchange is proposing new IM-2460-1 (Market Quality Program)⁴² 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, on the other hand, assiduously controls the exchange member/issuer relationship by setting 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.⁴³

⁴¹ 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, 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.

⁴² IM reflects interpretive material to an Exchange rule.

⁴³ 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), and also to the letter from Kenneth S. Spier, 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).

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 parties in the Program (e.g., MQP Companies and MQP Market Makers) 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. The positive aspects of the MQP are clear and unambiguous.⁴⁴

First, the entire Market Quality Program 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

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) (“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.

⁴⁴ 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 30, 31, and 32 and related text. Narrower spreads always benefits [sic] investors by lowering their transaction costs.

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 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.⁴⁵ Second, an MQP Market Maker must go through a separate MQP application process, and the Exchange

⁴⁵ 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.

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.⁴⁶ Third, in terms of flow of funds, the Exchange stands between an MQP Company and an MQP Market Maker. An MQP Company cannot and does not, under any circumstances, pay any funds to an MQP Market Maker that makes a market in the MQP Company's product pursuant to the Program. This is crucial. 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 by the Exchange - is to maintain a quality market in terms of the spread and liquidity of an MQP Security.⁴⁷ The Program does not afford any other way for an MQP Market Maker to earn an MQP Credit. The 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 interest⁴⁸

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

⁴⁶ 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 (e.g., Rule 4613) and the specific MQP market quality standards to be able to attain an MQP Credit.

⁴⁷ 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).

⁴⁸ 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.

lacking access to quality markets with adequate liquidity.⁴⁹ 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 and the PFMM concept. And third, if the Exchange desires to expand the pilot program or make the MQP permanent, the Exchange will need to file a new rule change proposal 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 available at the inside, reducing transaction costs, supporting the quality of price discovery, promoting market transparency, and improving investor protection.

Proposed Rule 5950 - Securities Eligible for the MQP

The MQP is available to Companies 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, LS, or TIR pursuant to Rules 5705, 5710, and 5720, respectively.⁵⁰ 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.⁵¹

⁴⁹ These securities may include less actively traded or less well known ETF products that have less well known or start-up companies as components.

⁵⁰ The Exchange believes that the Companies most likely to list on the MQP, and pay the requisite MQP listing fees, will be ETF family sponsors.

⁵¹ Proposed Rule 5950(b)(1).

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.⁵² 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 and an MQP Market Maker into the Program.⁵³ NASDAQ may, on a Program-wide basis, limit the number of MQP Securities that any one MQP Company may list in the MQP; any limitation would be uniformly applied to all MQP Companies.⁵⁴ In determining to limit the number of MQP Securities 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.⁵⁵

Moreover, to further enhance the transparency of the Program, proposed Rule

⁵² See Proposed Rule 5950(a). Thus for an MQP Company to be liable for payment of MQP Fees pursuant to 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).

⁵³ Proposed Rule 5950(a)(1)(C).

⁵⁴ 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).

⁵⁵ 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).

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.

An MQP Company and an MQP Market Maker may choose to withdraw from the Program. After an MQP Company is in the MQP for six consecutive months but less than one year, it may voluntarily withdraw 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.⁵⁶ After an MQP Company 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.⁵⁷ 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.⁵⁸

After an MQP Company 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 NAQSAQ [sic] terminates the Program by providing not less than one month prior notice of intent to terminate; 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 this

⁵⁶ 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).

⁵⁷ Proposed Rule 5950(a)(2)(B).

⁵⁸ Proposed Rule 5950(a)(2)(C).

rule.⁵⁹

Proposed Rule 5950 - MQP Fees From MQP Companies

An MQP Company seeking to participate in the MQP must pay to NASDAQ an annual basic MQP Fee of \$50,000 per MQP Security. The basic MQP Fee must be paid in quarterly installments as billed by NASDAQ. The basic MQP Fee will be allocated as follows: 50% will fund the Quote Share Payment that is based on Qualified Quotes; and 50% will fund the Trade Share Payment that is based on Qualified Trades, as defined and described below.⁶⁰

An MQP Company may also choose to pay an annual supplemental MQP Fee per MQP Security. The basic MQP Fee and supplemental MQP Fee when combined will not exceed \$100,000 per year. The supplemental MQP Fee must be paid, together with the basic MQP Fee, in quarterly installments as billed by NASDAQ. The amount of the supplemental MQP Fee, if any, will be determined by the MQP Company on an annual basis. The supplemental MQP Fee

⁵⁹ Proposed Rule 5950(a)(3).

⁶⁰ Proposed Rule 5950(b)(2)(A). Moreover, Trade Share Payments will be based upon each MQP Market Maker's share of total Qualified Trades in an MQP Security executed on the NASDAQ Market Center. 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. Proposed Rule 5950(c)(2)(B).

The Exchange believes that allocation of MQP Fees to Quote Share Payments and Trade Share Payments properly reflects the efforts of MQP Market Makers to improve the quality, depth, and/or liquidity of these securities (e.g., from initial quotation to final trade and execution). The Exchange believes that the combination of quote and trade payments in the Program is more effective in measuring the participation of an MQP Market Maker and the resulting liquidity that is added to the marketplace. A traditional per share incentive plan (e.g., a make-take pricing model) often is not attractive to market makers in respect of low volume securities because of the risk associated with the liquidity characteristics of the security coupled with the low volume and reduced revenue opportunity; from the perspective of market makers the costs may outweigh the benefit of liquidity provision. Additionally, by including a component dedicated to quote quality, the program provides an incentive to narrow spreads and increase the size at NBBO even when there are few or no trades occurring. As such, the Exchange believes that as MQP Market Makers increase the overall quality of the market it is important to compensate them for both their quote and trade participation in targeted securities.

must be paid, together with the basic MQP Fee, to NASDAQ in quarterly installments. An MQP Company shall indicate the proportions between 0% and 100% in which the supplemental MQP Fee will be allocated to the Quote Share Payment and/or Trade Share Payment. NASDAQ will provide notification on its website regarding the amount, if any, of the supplemental MQP Fee and the Quote Share Payment/Trade Share Payment allocation determined by an MQP Company.⁶¹

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.⁶²

The MQP Fee will be paid to the Exchange on a quarterly basis as billed by the Exchange, and will be credited to one or more MQP Market Makers that qualify for such credit for an MQP Security pursuant to proposed Rule 5950. NASDAQ will bill MQP Companies in arrears. NASDAQ will, at the beginning of a quarter, bill each MQP Company for the quarterly portion of an MQP Company's MQP Fee (basic and supplemental) for an MQP Security. Each such quarterly bill will be based on the MQP Credit that one or more MQP Market Makers in an MQP Security qualified for in the immediately preceding quarter pursuant to this rule.⁶³ All revenue from MQP Fees (basic and supplemental) will be credited pro rata to the eligible MQP Market Maker(s) in an MQP Security. Any portion of an MQP Fee that is not credited to eligible MQP Market Makers will be refunded to the MQP Company.⁶⁴

Proposed Rule 5950 - MQP Credit to Market Makers

When making a market in an MQP Security, an MQP Market Maker must, in addition to

⁶¹ Proposed Rule 5950(b)(2)(B).

⁶² Proposed Rule 5950(b)(2)(C).

⁶³ Proposed Rule 5950(b)(2)(D).

⁶⁴ Proposed Rule 5950(b)(2)(E).

fulfilling the market making obligations per Rule 4613,⁶⁵ 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 Session⁶⁶ as averaged over the course of a month, an MQP Market Maker must maintain: (a) at least 500 shares of attributable, displayed quotes⁶⁷ 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

⁶⁵ 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.

⁶⁶ The term “Regular Market Session” shall have the meaning given in Rule 4120(b)(4)(D). Proposed Rule 5950(e)(8).

⁶⁷ These are quotes that are attributable to members and not hidden quotes.

MQP Security.⁶⁸

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. Each MQP Credit will be comprised of a Quote Share Payment that is based on Qualified Quotes, and a Trade Share Payment that is based on Qualified Trades.⁶⁹ 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, 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

⁶⁸ 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.

⁶⁹ 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.

NBBO.⁷⁰

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.⁷¹

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 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 [sic] Market Maker application.⁷²

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 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;⁷³ (2) volume metrics; (3) number of MQP Market Makers in target securities; (4) spread size; and (5) availability of shares at the NBBO.

⁷⁰ Proposed Rule 5950(c)(2)(B). See also supra note 60.

⁷¹ Proposed Rule 5950(c)(2)(C).

⁷² Proposed Rule 5950(c)(3). See also supra note 54.

⁷³ 17 CFR 242.605.

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

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 surveillance procedures for derivative products including ETFs.⁷⁴ The Exchange may obtain information via the Intermarket Surveillance Group ("ISG") from other exchanges that are members or affiliates of the ISG⁷⁵ 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,⁷⁶ in general, and with Sections 6(b)(4) and 6(b)(5) of the Act,⁷⁷ 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 -

⁷⁴ FINRA surveils trading on the Exchange pursuant to a regulatory services agreement. The Exchange is responsible for FINRA's performance under this regulatory services agreement.

⁷⁵ For a list of the current members and affiliate members of ISG, see www.isgportal.com.

⁷⁶ 15 U.S.C. 78f.

⁷⁷ 15 U.S.C. 78f(b)(4) and (5).

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 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.⁷⁸

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 committed Market Makers, 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

⁷⁸ 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>.

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 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 fees among Market Makers that choose to participate and fulfill the obligations imposed by the rule. If one Market Maker fulfills those obligations, the MQP Fee will be distributed to that Market Maker; if multiple Market Makers satisfy the standard, the MQP Fee will be distributed pro rata among them. Any portion of an MQP Fee that is not credited to eligible MQP Market Makers will be refunded to the relevant MQP Company. All fees paid by issuers choosing to participate in the MQP, both initial and supplemental MQP Fees, will be available for distribution to eligible NASDAQ Market Makers. In other words, all of the benefit of the MQP Fees will flow to high-performing

Market Makers rather than to NASDAQ, 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, both for issuers and for Market Makers, 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.

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 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.

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 requests comment, in particular, on the following aspects of the proposed rule change:

1. Much of the reasoning, empirical data, and academic literature discussed by NASDAQ in its proposal is based on providing market making incentives to

enhance the market quality of, and capital formation for, smaller operating companies. However, the MQP proposed by NASDAQ would apply only to certain exchange-traded derivative securities products (defined in the proposal as MQP Securities to include Exchange Traded Funds, Linked Securities, and Trust Issued Receipts), and not to operating companies. Are the same arguments and rationale discussed by NASDAQ for operating companies equally applicable to exchange-traded products? Would the reported effects of other market-making incentive programs designed to enhance the market quality of traded operating companies be similar if applied to exchange-traded products? If so, how so? If not, why not?

2. How, if at all, might a market-making incentive program applied to exchange-traded products impact the operating companies that comprise the index underlying such exchange-traded products? Under what circumstances could an impact on those companies be beneficial or harmful? Could any impact differ depending on whether or not an exchange-traded product uses derivatives to gain exposure to such companies, or uses leverage or inverse leverage?
3. What are commenters' views on NASDAQ's assertion that being included as a "component" of an exchange-traded product (such as an ETF) results in benefits to an individual operating company? Do commenters agree with this assertion? Why or why not? Could such benefits arise independently from a company's inclusion in an underlying index, regardless of whether an exchange-traded product tracking such an index is traded? Is there any data available that analyzes the impact on a company when it becomes a component of an underlying index

versus when it becomes a portfolio component of an exchange-traded product that tracks such an index?

4. How does the rationale in support of trading lesser-known or smaller operating companies translate to the need for similar support of an exchange-traded product that tracks these companies? What about an exchange-traded product that tracks and invests in very liquid companies, but itself has low levels of liquidity? Is there an independent rationale for needing to support these types of exchange-traded products when the market does not? Are there unintended consequences of incentivizing such products? If so, what are they?
5. Given the inherent arbitrage link between trading exchange-traded products and their underlying holdings, why would a lack of liquidity in such a product impact the ability of market makers to quote relatively narrow bids and offers? What, if anything, does a lack of liquidity or wide bid-ask spread in an exchange-traded product indicate about the ability of a market maker to make effective use of arbitrage and the creation/redemption mechanisms often associated with exchange-traded products? How, if at all, would a market-making incentive program affect any intraday premium (discount) of the traded price of an exchange-traded product above (below) its intraday indicative value?
6. NASDAQ states that the MQP is designed to promote market quality in MQP Securities by, among other things, encouraging narrow spreads and greater liquidity. Under the proposal, MQP Market Makers would receive MQP Credits for quoting at or near the NBBO, regardless of the actual NBBO spread. The Commission seeks specific commentary on any potential impact of the proposed

rules on the market quality of the MQP Securities. Do commenters agree with the Exchange that the MQP would encourage tighter quoted prices and greater quoted size at the NBBO for MQP Securities? If so, please explain. If not, why not?

7. Do commenters believe that the MQP would result in MQP Market Makers quoting at better prices (and larger sizes) than they would otherwise quote without the incentives provided by the Program? Why or why not?
8. If the market qualities of two securities share similar characteristics (quoted spread, size, volume, etc.) but one is supported by MQP incentives and the other is not, what, if anything, does that suggest about the comparative robustness of those market qualities? Are there aspects of this type of incentivized market quality that should concern investors? Are such apparent improvements in market quality consistent with the Act and investor protection? Why or why not?
9. FINRA Rule 5250 prohibits FINRA members from directly or indirectly accepting payment from an issuer of a security for acting as a market maker. NASDAQ notes in its filing that it expects FINRA to file a proposed rule change to amend its Rule 5250 to exempt NASDAQ programs, such as the MQP, that are approved by the Commission. In addition, NASDAQ has its own rule, substantially similar to FINRA Rule 5250, which prohibits direct or indirect payment by an issuer to a market maker. The Exchange stated that it designed the MQP to meet the goals of market integrity, investor confidence, and clear member standards discussed in the Commission's order approving NASD Rule 2460

(which is now FINRA Rule 5250).⁷⁹ Do commenters believe the MQP would or would not raise concerns regarding investor confidence, market integrity, and member standards? For example, NASD Rule 2460 was implemented, in part, to address concerns about issuers paying market makers to improperly influence the price of an issuer's stock.⁸⁰ What are commenters' views on whether, and if so, how, the MQP would be consistent with this basis?

10. Could there be conflicts of interest between an MQP Company (the issuer) and the designated MQP Market Maker(s) for such MQP Securities participating in the Program? If so, what are those conflicts of interest?⁸¹ Please explain whether

⁷⁹ See Securities Exchange Act Release No. 38812 (July 3, 1997), 62 FR 37105 (July 10, 1997) (SR-NASD-97-29).

⁸⁰ See *id.* at 37107 (“Specifically, the Commission finds that the rule preserves the integrity of the marketplace by ensuring that quotations accurately reflect a broker-dealer’s interest in buying or selling a security. The decision by a firm to make a market in a given security and the question of price generally are dependent on a number of factors, including, among others, supply and demand, the firm’s expectations toward the market, its current inventory position, and exposure to risk and competition. This decision should not be influenced by payments to the member from issuers or promoters. Public investors expect broker-dealers’ quotations to be based on the factors described above. If payments to broker-dealers by promoters and issuers were permitted, investors would not be able to ascertain which quotations in the marketplace are based on actual interest and which quotations are supported by issuers or promoters. This structure would harm investor confidence in the overall integrity of the marketplace. The Commission finds that the proposed rule supports a longstanding policy and position of the NASD and establishes a clear standard of fair practice for member firms.”)

⁸¹ The Commission’s order approving NASD Rule 2460 discussed conflicts of interest that may exist between issuers and market makers. See *id.* at 37106 (“It has been a longstanding policy and position of the NASD that a broker-dealer is prohibited from receiving compensation or other payments from an issuer for quoting, making a market in an issuer’s securities or for covering the member’s out-of-pocket expenses for making a market, or for submitting an application to make a market in an issuer’s securities. As stated in Notice to Members 75-16 (February 20, 1975), such payments may be viewed as a conflict of interest since they may influence the member’s decision as to whether to quote or make a market in a security and, thereafter, the prices that the member would quote.”)

NASDAQ's proposal adequately addresses such potential conflicts.

11. In order to address concerns about potential conflicts of interest between issuers and market makers, NASDAQ stated that it designed the MQP to have clear and precise standards for all parties in the Program (e.g., MQP Companies and MQP Market Makers).⁸² Should such participation standards also be objective to ensure that there is a level playing field in determining who the issuers and market makers are for a particular MQP Security in the Program? Are the proposed criteria for participation by potential MQP Market Makers and/or potential MQP Companies in the MQP sufficiently clear, precise, and objective? Why or why not?
12. Is it appropriate and consistent with the Act to allow MQP Companies to pay the additional Supplemental MQP Fee at their discretion? Why or why not? Is it appropriate and consistent with the Act to allow MQP Companies to be able to decide how to allocate their Supplemental MQP Fee between Quote Share Payments and Trade Share Payments? Why or why not? What would be the impact on market maker incentives of allowing MQP Companies to pay the additional Supplemental MQP Fee and to decide how to allocate its Supplemental MQP Fee between Quote Share Payments and Trade Share Payments? Please explain.
13. With respect to a series of MQP Securities, should the MQP Company paying the MQP Fee be the sponsor or the fund? What impact, if any, would it have on fund investors if the fund pays the MQP Fee as opposed to the sponsor? Are the

⁸² See supra note 44 and accompanying text.

proposed Rules sufficiently clear as to which entity will be paying the MQP Fee?

14. Section 11(d)(1) of the Act generally prohibits a firm that is both a broker and a dealer in securities from extending or maintaining any credit on any new issue security if the broker-dealer participated in the distribution of the new issue security within the preceding 30 days. The Commission has granted relief to authorized participants from these restrictions if, among other things, neither the broker-dealer authorized participant, nor any natural person associated with such broker-dealer authorized participant, directly or indirectly, receives from the fund complex any payment, compensation, or other economic incentive to promote or sell the shares of the fund to persons outside the fund complex, other than non-cash compensation permitted under NASD Rule 2380. Should authorized participants participating in the creation and redemption of shares of MQP Securities that are also MQP Market Makers in those same MQP Securities be eligible to receive MQP Credits derived from Trade Share Payments? Would MQP Credits derived from Trade Share Payments give these authorized participants economic incentives to promote or sell shares of the MQP Security? Should such payments be viewed by the Commission as coming directly or indirectly from the fund complex of the MQP Security? Should MQP Credits derived from Trade Share Payments disqualify broker-dealer authorized participants from relying on the Commission's exemption from Section 11(d)(1) of the Act?
15. Could the MQP have an impact (either positive or negative) on incentives for market making in other exchange-traded products listed and traded on NASDAQ

that are not eligible for and/or do not participate in the Program, either because NASDAQ has limited the total number of MQP Securities that any one MQP Company may have in the MQP, the MQP Company does not qualify for the MQP, or the MQP Company's application for participation is otherwise denied? If so, what type of impact, and why? If not, why not? Please explain.

16. Proposed Rule 5950(d)(1)(A) states that the MQP will terminate if an MQP Security sustains an average NASDAQ ATV of two million shares or more for three consecutive months. Is this proposed threshold for discontinuance in the Program reasonable? If so, why? If not, why not? Should there be an alternative threshold or measure to determine termination from the Program? Please explain.
17. Could the MQP have unintended consequences on fair and orderly markets in an MQP Security when such security leaves the program? If so, what could these consequences be? If not, why not? Please explain.
18. NASDAQ has proposed to implement the MQP on a one-year pilot basis. Is one-year a reasonable time period during which to assess the impact of the proposed rules? If not, why not? Please explain.
19. What additional data, if any, should be provided by NASDAQ to help assess during the pilot period whether the MQP is achieving its stated goals? For example, if the Exchange required MQP Securities to be listed and traded outside the MQP for a period of time before being eligible for the MQP, could such a requirement provide useful "before and after" data for MQP Securities to permit the Exchange and the Commission to more accurately assess the market quality of the securities before participating in the Program and the market quality of the

same securities while participating in the Program? If so, how? If not, please explain.

20. The MQP proposed rule provides for certain public disclosures relating to the Program (i.e., notifications on NASDAQ's website will include 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, the amount of the supplemental MQP Fee, etc.).⁸³ Do commenters believe that these disclosures would provide sufficient information to investors? If not, why not? Is there any other information that the Exchange should provide on its website regarding the MQP and participating MQP Securities, MQP Companies, and MQP Market Makers? For example, should NASDAQ be required to provide notification on its website of any notices from an MQP Company or MQP Market Maker to withdraw from the Program? What advantages or disadvantages would such disclosure provide? Please explain.
21. Would it be helpful to investors to have public notice of an MQP Company's participation in the Program through means other than on the Exchange's website, such as in the MQP Company's periodic reports to the Commission, on the MQP Company's website, or through a ticker symbol identifier on the consolidated tape? Why or why not?
22. What are commenters' views on whether the proposed disclosures are sufficient

⁸³ See Proposed Rule 5950(a)(1)(C) and (b)(2)(B)(iii).

to enable all investors, even less sophisticated investors, to understand the potential impact of the proposed MQP on the market quality of an MQP Security, including that an MQP Company's participation in the Program is voluntary and subject to withdrawal, or that the MQP Security may become ineligible for the Program if its trading volume reaches sufficiently high levels?

23. Should the Exchange be required to publicly (and anonymously) disclose statistics on the performance of MQP Market Makers? Would such disclosure provide meaningful information to investors (e.g., would such disclosure provide investors the opportunity to assess how much perceived liquidity is being provided by MQP Market Makers, as opposed to liquidity provided by market makers and other market participants who are not paid an MQP Credit)? If so, what information should be disclosed and why? If not, why not? What advantages or disadvantages would such disclosure provide? Please explain.

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. Please include File Number SR-NASDAQ-2012-043 on the subject line.

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-2012-043. 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-2012-043 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.⁸⁴

Kevin M. O'Neill
Deputy Secretary

⁸⁴ 17 CFR 200.30-3(a)(12).