

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-69706; File No. SR-NYSEArca-2013-34)

June 6, 2013

Self-Regulatory Organizations; NYSE Arca, Inc.; Order Granting Approval of a Proposed Rule Change, as Modified by Amendment Nos. 1 and 2 Thereto, to Implement a One-Year Pilot Program for Issuers of Certain Exchange-Traded Products Listed on the Exchange

On March 21, 2013, NYSE Arca, Inc. (“Exchange” or “NYSE Arca”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to implement the NYSE Arca ETP Incentive Program (“Incentive Program”), a one-year pilot program for issuers of certain exchange-traded products (“ETPs”) listed on the Exchange. On April 5, 2013, the Exchange submitted Amendment No. 1 to the proposed rule change, which replaced and superseded the proposed rule change in its entirety.<sup>3</sup> The proposed rule change, as modified by Amendment No. 1, was published for comment in the Federal Register on April 11, 2013.<sup>4</sup> The Commission received two comment letters on the proposal.<sup>5</sup> On May 29, 2013, the Exchange submitted Amendment No. 2 to the proposed rule change.<sup>6</sup> This order grants approval of the proposed rule change, as modified by Amendment Nos. 1 and 2 thereto.<sup>7</sup>

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

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

<sup>3</sup> SR-NYSEArca-2013-34 replaced and superseded SR-NYSEArca-2012-37, which was withdrawn by the Exchange. See Securities Exchange Act Release Nos. 66966 (May 11, 2012), 77 FR 29419 (May 17, 2012) and 68616 (Jan. 10, 2013), 78 FR 3482 (Jan. 16, 2013) (SR-NYSEArca-2012-37).

<sup>4</sup> See Securities Exchange Act Release No. 69335 (Apr. 5, 2013), 78 FR 21681 (“Notice”).

<sup>5</sup> See Letter from John T. Hyland, Chief Investment Officer, United States Commodity Funds LLC, dated Apr. 10, 2013 (“USCF Letter”), and Letter from Stanislav Dolgoplov, Assistant Adjunct Professor, UCLA School of Law, dated Apr. 26, 2013 (“Dolgoplov Letter”).

<sup>6</sup> In Amendment No. 2, the Exchange proposed to: (i) amend the rule text to provide that an LMM in the Incentive Program will remain obligated to satisfy the general

## I. Description of the Proposal

As set forth in more detail in the Notice,<sup>8</sup> the Exchange is proposing to adopt new NYSE Arca Equities Rule 8.800 and to amend its fee schedules to set forth the requirements for the Incentive Program, which will be a one-year pilot program for issuers of certain ETPs listed on the Exchange.<sup>9</sup> The Exchange states that the Incentive Program is designed to enhance the market quality for ETPs by incentivizing Market Makers<sup>10</sup> to take Lead Market Maker (“LMM”) assignments in certain lower volume ETPs by offering an alternative fee structure for such

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requirements of NYSE Arca Equities Rule 7.23, rather than the general requirements of NYSE Arca Rule 7.23; (ii) amend the rule text to provide that the Exchange will disclose on its website the date it receives written notice of an issuer’s intent to withdraw its ETP from the Incentive Program, or an LMM’s (as defined herein) intent to withdraw from its ETP assignment(s) in the Incentive Program, and, in each case, the intended withdrawal date, if provided; and (iii) clarify that the Exchange’s monthly public report to the Commission relating to the Incentive Program will (a) compare, to the extent practicable, ETPs before and after they are in the Incentive Program, and will further provide data and analysis about the market quality of ETPs that exceed the one million CADV (as defined herein) threshold and “graduate,” or are otherwise withdrawn or terminated from, the Incentive Program, and (b) include market quality data for comparable ETPs that are listed on the Exchange but not participating in the Incentive Program. Amendment No. 2 provides clarification to the proposed rule change, and because it does not materially affect the substance of the proposed rule change, Amendment No. 2 does not require notice and comment.

<sup>7</sup> Today the Commission also is granting exemptive relief from Rule 102 under Regulation M concerning the Incentive Program. See Securities Exchange Act Release No. 69707 (June 6, 2013) (Order Granting a Limited Exemption from Rule 102 of Regulation M Concerning the NYSE Arca, Inc.’s Exchange-Traded Product Incentive Program Pilot Pursuant to Regulation M Rule 102(e)).

<sup>8</sup> See Notice, supra note 4.

<sup>9</sup> The Exchange currently has two Schedules of Fees and Charges for Exchange Services; one that is for listings (“Listing Fee Schedule”) and another that is for trade-related charges (“Trading Fee Schedule”). To differentiate them, the Exchange also proposes to change the name of the Listing Fee Schedule to “Schedule of Fees and Charges for Exchange Listing Services.”

<sup>10</sup> A Market Maker is an Equity Trading Permit Holder (“ETP Holder”) that acts as a Market Maker pursuant to NYSE Arca Equities Rule 7. See NYSE Arca Equities Rule 1.1(v). An ETP Holder is a sole proprietorship, partnership, corporation, limited liability company, or other organization in good standing that has been issued an Equity Trading Permit. See NYSE Arca Equities Rule 1.1(n).

LMMs that would be funded from the Exchange’s general revenues.<sup>11</sup> The Exchange states that participation in the Incentive Program would be entirely voluntary on the part of both LMMs and issuers, and that the costs of the Incentive Program would be offset by charging participating issuers non-refundable “Optional Incentive Fees,” which would be credited to the Exchange’s general revenues.<sup>12</sup>

A. Eligible Products, Issuer Application, and LMM Assignment

An ETP will be eligible to participate in the Incentive Program if (i) it is listed on the Exchange as of the commencement of the pilot period or becomes listed during the pilot period; (ii) the listing is under NYSE Arca Equities Rules 5.2(j)(3) (Investment Company Units), 5.2(j)(5) (Equity Gold Shares), 8.100 (Portfolio Depositary Receipts), 8.200 (Trust Issued Receipts), 8.201 (Commodity-Based Trust Shares), 8.202 (Currency Trust Shares), 8.203 (Commodity Index Trust Shares), 8.204 (Commodity Futures Trust Shares), 8.300 (Partnership Units), 8.600 (Managed Fund Shares), or 8.700 (Managed Trust Securities); (iii) with respect to an ETP that listed on the Exchange before the commencement of the Incentive Program, the ETP has a consolidated average daily volume (“CADV”) of one million shares or less for at least the preceding three months and the issuer of such ETP has not suspended the issuance or redemption of new shares;<sup>13</sup> and (iv) it is compliant with continuing listing standards, if the ETP was added to the Incentive Program after listing on the Exchange.<sup>14</sup>

An issuer that wishes to have an ETP participate in the Incentive Program and pay the Exchange an Optional Incentive Fee will be required to submit a written application in a form

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<sup>11</sup> See Notice, supra note 4, at 21682.

<sup>12</sup> Id.

<sup>13</sup> The Exchange maintains a list of ETPs that have suspended the issuance of new shares, which is available at <https://etp.nyx.com/en/trading-information/us/funds-closed-creation>.

<sup>14</sup> See proposed NYSE Arca Equities Rule 8.800(a).

prescribed by the Exchange for each ETP.<sup>15</sup> An issuer may apply to have its ETP participate at the time of listing or thereafter at the beginning of each quarter during the pilot period.<sup>16</sup> An issuer may not have more than five ETPs that were listed on the Exchange prior to the pilot period participate in the Incentive Program.<sup>17</sup> However, there will be no limitation on the number of ETPs per issuer listed during the pilot period that can participate in the program.<sup>18</sup> In order for its ETP to be eligible to participate in the Incentive Program, an issuer must be current in all payments due to the Exchange.<sup>19</sup>

Proposed NYSE Arca Equities Rule 8.800(b)(3) provides that the Exchange will communicate the ETP(s) proposed for inclusion in the Incentive Program on a written solicitation that will be sent to all qualified LMMs<sup>20</sup> along with the Optional Incentive Fee the issuer will pay the Exchange for each ETP. The issuer will determine the amount of the Optional Incentive Fee for each ETP within a permitted range that will be set forth in the Exchange's Listing Fee Schedule.<sup>21</sup> Proposed NYSE Arca Equities Rule 8.800(b)(4) provides that after the Exchange provides the written solicitation to LMMs, no individual associated with an LMM may contact such issuer or the Exchange staff about that ETP until the assignment of the LMM is

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<sup>15</sup> See proposed NYSE Arca Equities Rule 8.800(b)(1).

<sup>16</sup> Id.

<sup>17</sup> Id.

<sup>18</sup> See Notice, supra note 4, at 21685.

<sup>19</sup> See proposed NYSE Arca Equities Rule 8.800(b)(2)

<sup>20</sup> The written solicitation will be included in the "Green Sheet," which is the common term for an email communication sent by Exchange staff members to all qualified LMMs prior to an LMM selection. The Green Sheet includes, among other things, the name, symbol and description of the ETP(s) as well as the name of the issuer and a link to the ETP prospectus. A qualified LMM must complete the application for a specific ETP or group of ETPs. See Notice, supra note 4, at 21685-6, n.15.

<sup>21</sup> See proposed NYSE Arca Equities Rule 8.800(b)(3). See also Section I(C) infra for further discussion of the Optional Incentive Fee.

made, except as otherwise permitted in the proposed rules. If more than one qualified LMM proposes to serve as such for a particular ETP, Exchange staff will select the LMM pursuant to the provisions set forth in the proposed rules.<sup>22</sup> The issuer of the ETP may choose to submit a letter to the Exchange staff indicating its preference and supporting justification for a particular LMM, and the Exchange staff may consider such letter in performing its duty to select an LMM, but such letter will not be determinative of the particular LMM selected by the Exchange.<sup>23</sup> Within two business days after the final LMM interview, the Exchange staff, in its sole discretion, will select an LMM and notify the LMM and the issuer.<sup>24</sup>

**B. Disclosure Relating to the Incentive Program**

Pursuant to proposed NYSE Arca Equities Rule 8.800(b)(6), the Exchange will provide notification on a dedicated page on its website regarding: (i) the ETPs participating in the Incentive Program; (ii) the date a particular ETP begins participating and ceases participating in the Incentive Program; (iii) the LMM assigned to each ETP participating in the Incentive Program; (iv) the date the Exchange receives written notice of an issuer's intent to withdraw its ETP from the Incentive Program, or an LMM's intent to withdraw from its ETP assignment(s) in the Incentive Program, and, in each case, the intended withdrawal date, if provided; and (v) the

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<sup>22</sup> See proposed NYSE Arca Equities Rule 8.800(b)(5). An LMM may provide material to the Exchange staff, which may include a corporate overview of the LMM and the trading experience of its personnel. Exchange staff will meet with representatives of each LMM if requested by the LMM, and no more than three representatives of each LMM may participate in the meeting, each of whom must be employees of the LMM, and one of whom must be the individual trader of the LMM who is proposed to trade the ETP. If the LMM is unavailable to appear in person, a telephone interview with that LMM would be acceptable. Meetings will normally be held at the Exchange, unless the Exchange agrees that they may be held elsewhere. Id.

<sup>23</sup> Id.

<sup>24</sup> Id. Proposed NYSE Arca Equities Rule 8.800(b)(5) is modeled in part on New York Stock Exchange Rule 103B(III)(B)(1), which governs Designated Market Maker unit assignments for equities listed on the NYSE. See Notice, supra note 4, at 21686, n.20.

amount of the Optional Incentive Fee for each ETP.<sup>25</sup> This page will also include a fair and balanced description of the Incentive Program, including: (i) a description of the Incentive Program's operation as a pilot, including the effective date thereof; (ii) the potential benefits that may be realized by an ETP's participation in the Incentive Program; (iii) the potential risks that may be attendant with an ETP's participation in the Incentive Program; (iv) the potential impact resulting from an ETP's entry into and exit from the Incentive Program; and (v) how interested parties can request additional information regarding the Incentive Program and/or the ETPs participating therein.<sup>26</sup>

Under proposed NYSE Arca Equities Rule 8.800(b)(7), an issuer of an ETP that is approved to participate in the Incentive Program will be required to issue a press release to the public when an ETP commences or ceases participation in the Incentive Program. The press release will be in a form and manner prescribed by the Exchange, and if practicable, will be issued at least two days before the ETP commences or ceases participation in the Incentive Program.<sup>27</sup> The issuer also will be required to dedicate space on its website, or, if it does not have a website, on the website of the adviser or sponsor of the ETP, to (i) include any such press

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<sup>25</sup> See proposed NYSE Arca Equities Rule 8.800(b)(6). See also Amendment No. 2, supra note 6.

<sup>26</sup> See proposed NYSE Arca Equities Rule 8.800(b)(6).

<sup>27</sup> See proposed NYSE Arca Equities Rule 8.800(b)(7). The issuer's press release will be required to include language describing, for example, that while the impact of participation in or exit from the Incentive Program, which is optional, cannot be fully understood until objective observations can be made in the context of the Incentive Program, potential impacts on the market quality of the issuer's ETP may result, including with respect to the average spread and average quoted size for the ETP. See Notice, supra note 4, at 21686, n.21.

releases and (ii) provide a hyperlink to the dedicated page on the Exchange’s website that describes the Incentive Program.<sup>28</sup>

C. Optional Incentive Fee

The Exchange proposes to amend its Listing Fee Schedule to provide that the Optional Incentive Fee under NYSE Arca Rule 8.800 may initially range from \$10,000 to \$40,000, as determined by the issuer of an ETP.<sup>29</sup> The Optional Incentive Fee for each ETP will be paid by the issuer to the Exchange in quarterly installments at the beginning of each quarter and prorated if the issuer commences participation for an ETP in the Incentive Program after the beginning of a quarter.<sup>30</sup> If an LMM does not meet its performance standards (as described below) for an ETP in any given month in such quarter, the issuer would not receive any refund or credit from the Exchange following the end of the quarter.<sup>31</sup> If the ETP has a sponsor, the sponsor may pay the Optional Incentive Fee to the Exchange.<sup>32</sup>

D. Incentive Program LMM Performance Standards

Proposed NYSE Arca Equities Rule 8.800(c) describes the proposed Incentive Program LMM performance standards (“Incentive Program LMM Performance Standards”) that will

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<sup>28</sup> See proposed NYSE Arca Equities Rule 8.800(b)(7). The disclosure requirements set forth in the proposal would be in addition to, and would not supersede, the prospectus disclosure requirements under the Securities Act of 1933 or the Investment Company Act of 1940. See Notice, supra note 4, at 21686, n.22.

<sup>29</sup> See proposed Listing Fee Schedule. Optional Incentive Fees paid by an issuer will be credited to the Exchange’s general revenues. An issuer participating in the Incentive Program will still be required to pay applicable listing and annual fees. See Notice, supra note 4, at 21686, n.16.

<sup>30</sup> See proposed Listing Fee Schedule.

<sup>31</sup> Id.

<sup>32</sup> Id. The term “sponsor” means the registered investment adviser that provides investment management services to an ETP or any of such investment adviser’s parents or subsidiaries. Id.

apply to an LMM for each ETP participating in the Incentive Program to which it is assigned.

An LMM in the Incentive Program also will remain obligated to satisfy the general requirements of NYSE Arca Equities Rule 7.23.<sup>33</sup>

Pursuant to proposed NYSE Arca Equities Rule 8.800(c)(2), an LMM will be subject to a “Market-Wide Requirement.” Specifically, an LMM will be required to maintain quotes or orders at the National Best Bid or Offer (“NBBO”) or better (“Inside”) during the month during Core Trading Hours in accordance with the following maximum width and minimum depth thresholds, which are provided in proposed Commentary .01 to Rule 8.800.<sup>34</sup>

<u>Daily Share</u> <u>Volume</u>	<u>Quote Type</u>	<u>Requirement</u>	<u>Prices (\$)</u>			
			<u>0-4.99</u>	<u>5- 14.99</u>	<u>15- 49.99</u>	<u>50 or more</u>
<u>0-4,999</u>	<u>Inside</u>	<u>Width (%)</u>	<u>15.00</u>	<u>6.00</u>	<u>5.00</u>	<u>4.00</u>
		<u>Depth (sh)</u>	<u>700</u>	<u>400</u>	<u>300</u>	<u>200</u>
<u>5,000-24,999</u>	<u>Inside</u>	<u>Width (%)</u>	<u>7.00</u>	<u>3.00</u>	<u>2.00</u>	<u>1.50</u>
		<u>Depth (sh)</u>	<u>700</u>	<u>400</u>	<u>300</u>	<u>200</u>
<u>25,000-74,999</u>	<u>Inside</u>	<u>Width (%)</u>	<u>5.00</u>	<u>1.50</u>	<u>1.00</u>	<u>0.70</u>
		<u>Depth (sh)</u>	<u>700</u>	<u>400</u>	<u>300</u>	<u>200</u>
<u>75,000-199,999</u>	<u>Inside</u>	<u>Width (%)</u>	<u>3.00</u>	<u>1.00</u>	<u>0.50</u>	<u>0.30</u>

<sup>33</sup> See proposed NYSE Arca Equities Rule 8.800(c)(1). See also Amendment No. 2, *supra* note 6.

<sup>34</sup> See proposed NYSE Arca Equities Rule 8.800(c)(2). Proposed Commentary .01 to NYSE Arca Equities Rule 8.800 provides that (i) the spread thresholds will be calculated as the time-weighted average throughout the trading day and then averaged, by day, across the month and (ii) the depth thresholds will be calculated as the average of (a) the average time-weighted bid depth and (b) the average time-weighted ask depth.

		<u>Depth (sh)</u>	<u>700</u>	<u>400</u>	<u>300</u>	<u>200</u>
<u>200,000-499,999</u>	<u>Inside</u>	<u>Width (%)</u>	<u>2.00</u>	<u>0.60</u>	<u>0.30</u>	<u>0.20</u>
		<u>Depth (sh)</u>	<u>700</u>	<u>400</u>	<u>300</u>	<u>200</u>
<u>500,000 or more</u>	<u>Inside</u>	<u>Width (%)</u>	<u>1.00</u>	<u>0.30</u>	<u>0.20</u>	<u>0.10</u>
		<u>Depth (sh)</u>	<u>2000</u>	<u>1000</u>	<u>500</u>	<u>300</u>

However, the Market-Wide Requirement will not apply to an LMM if these thresholds are otherwise met by quotes or orders of all market participants across all markets trading the ETP.<sup>35</sup>

Pursuant to proposed NYSE Arca Equities Rule 8.800(c)(3), an LMM also will be subject to a NYSE Arca-specific requirement, which can be satisfied in one of two ways. First, an LMM may satisfy the “Time-at-the-Inside Requirement” under proposed NYSE Arca Equities Rule 8.800(c)(3)(A), pursuant to which an LMM will be required to maintain quotes or orders on the Exchange at the NBBO or better at least 15% of the time when quotes may be entered during Core Trading Hours each trading day, as averaged over the course of a month.<sup>36</sup> Alternatively, an LMM may choose to satisfy the “Size-Setting NBBO Requirement” under proposed NYSE Arca Equities Rule 8.800(c)(3)(B), pursuant to which an LMM will be required to maintain “size-setting” quotes or orders on the Exchange, as compared to trading interest on other markets, at the NBBO or better at least 25% of the time when quotes may be entered during Core Trading Hours each trading day, as averaged over the course of a month; provided, however, that

<sup>35</sup>

Id.

<sup>36</sup>

Proposed Commentary .01 to NYSE Arca Equities Rule 8.800 provides that the Time-at-the-Inside Requirement will be calculated as the average of (a) the percentage of time the LMM has a bid on the Exchange at the National Best Bid (“NBB”) and (b) the percentage of time the LMM has an offer on the Exchange at the National Best Offer (“NBO”).

the Size-Setting NBBO Requirement will not apply to an LMM if this threshold is otherwise met by quotes or orders of other market participants on NYSE Arca.<sup>37</sup>

Finally, under proposed NYSE Arca Equities Rule 8.800(c)(4), for at least 90% of the time when quotes may be entered during Core Trading Hours each trading day, as averaged over the course of a month, an LMM will be required to maintain (A) at least 2,500 shares of attributable, displayed posted buy liquidity on the Exchange that is priced no more than 2% away from the NBB for the particular ETP, and (B) at least 2,500 shares of attributable, displayed posted offer liquidity on the Exchange that is priced no more than 2% away from the NBO for the particular ETP.

Proposed Commentary .01 to NYSE Arca Equities Rule 8.800 provides that only displayed quotes and orders will be considered for purposes of the Incentive Program LMM Performance Standards.

E. LMM Payment

Proposed NYSE Arca Equities Rule 8.800(d) provides that the Exchange will credit an LMM for an “LMM Payment,” which will be determined by the Exchange and set forth in the Trading Fee Schedule. An LMM participating in the Incentive Program would not be entitled to an LMM Payment unless and until it meets or exceeds the Incentive Program LMM Performance

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<sup>37</sup> Proposed Commentary .01 to NYSE Arca Equities Rule 8.800 provides that : (i) the Size-Setting NBBO Requirement will be calculated throughout the trading day and then averaged, by day, across the month; (ii) quotes and orders of all market participants across all markets trading the security will be considered when calculating the Size-Setting NBBO Requirement; (iii) a quote or order will be considered “size-setting” if it is at the NBB or NBO; (iv) if multiple quotes or orders exist at the same price, the quote or order with the largest size will be considered “size-setting;” and (v) if multiple quotes or orders exist at the same price and the same size, the quote or order with the earliest entry time will be considered “size-setting.”

Standards for an assigned ETP, as determined by the Exchange.<sup>38</sup> LMM Payments will be paid by the Exchange from its general revenues.<sup>39</sup>

The Exchange proposes to amend its Trading Fee Schedule to provide that at the end of each quarter, the Exchange will credit an LMM an LMM Payment for each month during such quarter that the LMM meets or exceeds its Incentive Program LMM Performance Standards for an assigned ETP. If an LMM does not meet or exceed the Incentive Program LMM Performance Standards for an assigned ETP for a particular month, or the ETP is withdrawn from the Incentive Program, then the LMM Payment will be zero for such month.<sup>40</sup> The amount of the LMM Payment for a particular month will not exceed 1/3 of the quarterly Optional Incentive Fee, as determined by the issuer, less an Exchange administration fee of 5%.<sup>41</sup> LMMs participating in the Fixed Incentive Program will be subject to the transaction fees and credits applicable to ETP Holders and Market Makers for transactions in their assigned ETPs during the quarter instead of the LMM transaction fees and credits.<sup>42</sup> If an issuer does not pay its quarterly installments to the Exchange on time and the ETP continues to be listed, the Exchange will continue to credit the LMM if the LMM meets its Incentive Program LMM Performance Standards.<sup>43</sup>

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<sup>38</sup> See Notice, supra note 4, at 21687.

<sup>39</sup> Id.

<sup>40</sup> See proposed Trading Fee Schedule.

<sup>41</sup> Id.

<sup>42</sup> Id. The Exchange currently provides LMMs with an opportunity to receive incrementally higher transaction credits and incur incrementally lower transaction fees (“LMM Rates”) compared to standard liquidity maker-taker rates (“Standard Rates”). See Notice, supra note 4, at 21682. LMMs in the Incentive Program would be subject to the Standard Rates instead of the LMM Rates. Id. at 21687.

<sup>43</sup> See proposed Trading Fee Schedule.

F. Withdrawal and Reallocation

Proposed NYSE Arca Equities Rule 8.800(e) describes the circumstances for withdrawal from the Incentive Program. First, if an ETP no longer meets continuing listing standards, suspends the creation and/or redemption of shares, or liquidates, it will be automatically withdrawn from the Incentive Program as of the ETP suspension date.<sup>44</sup>

Second, the Exchange, in its discretion, may allow an issuer to withdraw an ETP from the Incentive Program before the end of the pilot period if the assigned LMM is unable to meet its Incentive Program LMM Performance Standards for any two of the three months of a quarter or for five months during the pilot period and no other qualified ETP Holder was able to take over the assignment.<sup>45</sup>

Third, an LMM may withdraw from all of its ETP assignments in the Incentive Program, or the Exchange, in its discretion, may allow an LMM to withdraw from a particular ETP before the end of the pilot period if the Exchange determines that there are extraneous circumstances that prevent the LMM from meeting its Incentive Program LMM Performance Standards for such ETP that do not affect its other ETP assignments in the Incentive Program.<sup>46</sup> In either case, the LMM's ETP(s) will be reallocated in accordance with proposed NYSE Arca Equities Rule 8.800(f) (described below).

Fourth, if an ETP maintains a CADV of one million shares or more for three consecutive months, it will be automatically withdrawn from the Incentive Program within one month thereafter.<sup>47</sup> If after such automatic withdrawal the ETP fails to maintain a CADV of one

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<sup>44</sup> See proposed NYSE Arca Equities Rule 8.800(e)(1).

<sup>45</sup> See proposed NYSE Arca Equities Rule 8.800(e)(2).

<sup>46</sup> See proposed NYSE Arca Equities Rule 8.800(e)(3).

<sup>47</sup> See proposed NYSE Arca Equities Rule 8.800(e)(4).

million shares or more for three consecutive months, the issuer of the ETP may reapply for the Incentive Program one month thereafter.<sup>48</sup>

Finally, if the issuer is not current in all payments due to the Exchange for two consecutive quarters, its ETP will be automatically terminated from the Incentive Program.<sup>49</sup>

Proposed NYSE Arca Equities Rule 8.800(f) describes the LMM reallocation process. If the LMM for a particular ETP does not meet or exceed its Incentive Program LMM Performance Standards for any two of the three months of a quarter or for five months during the pilot period, or chooses to withdraw from the Incentive Program, and at least one other qualified Market Maker has agreed to become the assigned LMM under the Incentive Program, then the ETP will be reallocated and another LMM will be solicited and assigned in accordance with proposed NYSE Arca Equities Rule 8.800(b).<sup>50</sup> The reallocation process will be completed no sooner than the end of the current quarter and no later than the end of the following quarter.<sup>51</sup>

#### G. Implementation of Pilot

The Incentive Program will be offered to issuers from the date of implementation, which will occur no later than 90 days after Commission approval of the filing, until one calendar year after implementation.<sup>52</sup> During the pilot period, the Exchange will assess the Incentive Program and may expand the criteria for ETPs that are eligible to participate, for example, to permit issuers to include more than five ETPs that were listed on the Exchange before the pilot period

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<sup>48</sup>

Id.

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See proposed NYSE Arca Equities Rule 8.800(e)(5).

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See proposed NYSE Arca Equities Rule 8.800(f).

<sup>51</sup>

Id.

<sup>52</sup>

See Notice, supra note 4, at 21688.

commenced.<sup>53</sup> At the end of the pilot period, the Exchange will determine whether to continue or discontinue the Incentive Program or make it permanent.<sup>54</sup>

During the Incentive Program, the Exchange will provide the Commission with certain market quality reports each month, which will also be posted on the Exchange's website.<sup>55</sup> Such reports will include the Exchange's analysis regarding the Incentive Program and whether it is achieving its goals, as well as market quality data such as (for all ETPs listed as of the date of implementation of the Incentive Program and listed during the pilot period for comparative purposes, including comparable ETPs that are listed on the Exchange but not participating in the Incentive Program): volume (CADV and NYSE Arca average daily volume); NBBO bid/ask spread differentials; LMM participation rates; NYSE Arca market share; LMM time spent at the inside; LMM time spent within \$0.03 of the inside; percent of time NYSE Arca had the best price with the best size; LMM quoted spread; LMM quoted depth; and Rule 605 statistics (one-month delay).<sup>56</sup> These reports will also compare, to the extent practicable, ETPs before and after they are in the Incentive Program, and will further provide data and analysis about the market quality of ETPs that exceed the one million CADV threshold and "graduate," or are otherwise withdrawn or terminated from, the Incentive Program.<sup>57</sup> In connection with the proposal, the Exchange will provide other data and information related to the Incentive Program as may be

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<sup>53</sup> Id. The Commission notes that any modifications to the terms of the proposal would require a rule filing with the Commission pursuant to Section 19(b) of the Exchange Act and Rule 19b-4 thereunder.

<sup>54</sup> The Commission notes that any proposed continuance of the Program or proposal to make the Program permanent would require a rule filing with the Commission pursuant to Section 19(b) of the Exchange Act and Rule 19b-4 thereunder.

<sup>55</sup> See Notice, supra note 4, at 21688.

<sup>56</sup> Id. See also Amendment No. 2, supra note 6.

<sup>57</sup> See Amendment No. 2, supra note 6.

periodically requested by the Commission.<sup>58</sup> In addition, the Exchange states that issuers may utilize ArcaVision to analyze and replicate data on their own.<sup>59</sup>

#### H. Surveillance

The Exchange represents that its surveillance procedures will be adequate to properly monitor the trading of ETPs participating in the Incentive Program on the Exchange during all trading sessions and to detect and deter violations of Exchange rules and applicable federal securities laws.<sup>60</sup> The Exchange states that trading of the ETPs through the Exchange will be subject to FINRA’s surveillance procedures for derivative products,<sup>61</sup> and that the Exchange may obtain information via the Intermarket Surveillance Group (“ISG”) from other exchanges that are members or affiliates of the ISG; and from issuers and public and non-public data sources such as, for example, Bloomberg.<sup>62</sup>

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<sup>58</sup> See Notice, supra note 4, at 21688.

<sup>59</sup> Id. NYSE Arca provides ArcaVision free of charge to the public via the website [www.ArcaVision.com](http://www.ArcaVision.com). According to the Exchange, ArcaVision offers a significant amount of trading data and market quality statistics for every Regulation NMS equity security traded in the United States, including all ETPs. Publicly available reports within ArcaVision, which include relevant comparative data, are the Symbol Summary, Symbol Analytics, Volume Comparison and Quotation Comparison reports, among others. In addition, users can create the reports on a per-symbol basis over a flexible time frame and can also take advantage of predefined symbol sets based on type of ETP or issuer. Users can also create their own symbol lists. The Exchange states that ArcaVision allows an ETP issuer to see additional information specific to its LMM and other Market Makers in each ETP via the “ArcaVision Market Maker Summary” reporting mechanism. Id.

<sup>60</sup> See Notice, supra note 4, at 21690.

<sup>61</sup> FINRA surveils trading on the Exchange, including ETP trading, pursuant to a Regulatory Services Agreement (“RSA”). The Exchange is responsible for FINRA’s performance under this RSA. Id. at 21689, n.29

<sup>62</sup> Id. at 21690.

## II. Summary of Comment Letters

The Commission received two comment letters in support of the proposed rule change.<sup>63</sup> One commenter states that it supports regulatory changes that result in more efficient markets for issuers of ETPs and thus supports the Incentive Program.<sup>64</sup> This commenter encourages programs that make it possible for all firms to attempt to list new and innovative securities in the marketplace and have an opportunity to receive adequate support from the market making community, as the commenter believes such developments directly benefit new entrants, existing small competitors, and investors.<sup>65</sup> This commenter emphasizes that the program is being implemented as a pilot and thus will be fairly easy for either the Exchange or the Commission to alter or terminate with little or no negative consequences to the marketplace.<sup>66</sup> Further, the commenter states its observation that the current market model does not encourage broker/dealers to assume the additional responsibilities of being an LMM and that this proposal should encourage more market makers to become LMMs.<sup>67</sup> The commenter suggests that the success of the program should be measured by the increase in the number of firms willing to act as an LMM under the proposal, rather than how tight spreads are in ETPs subject to the pilot.<sup>68</sup>

Another commenter points out that several academic studies have found that the imposition of market making obligations in exchange for certain privileges tends to enhance market quality, resulting in improved economic efficiency rather than mere wealth transfers.<sup>69</sup>

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<sup>63</sup> See USCF Letter and Dolgoplov Letter, supra note 5.

<sup>64</sup> See USCF Letter, supra note 5, at 1.

<sup>65</sup> Id. at 2.

<sup>66</sup> Id. at 1.

<sup>67</sup> Id. at 1-2.

<sup>68</sup> Id. at 2.

<sup>69</sup> See Dolgoplov Letter, supra note 5, at 3, citing to the following studies: Amber Anand

This commenter states that, to the extent the Incentive Program promotes the adoption of trading obligations that enhance liquidity, it is likely to promote economic efficiency.<sup>70</sup> The commenter states that while there may be some concerns that payments to market makers represent subsidies, this should not necessarily be viewed negatively, as studies have shown that the subsidization of liquidity can improve economic welfare and increase “the size of the pie.”<sup>71</sup> The commenter further argues that a direct subsidy in the form of regular payments from issuers/sponsors to market makers, such as the one proposed pursuant to the Incentive Program, may have an advantage over traditional indirect subsidies provided to market makers (e.g., time or information advantages, order flow allocation, etc.), which have historically been subject to abuse, insofar as the fees and payments under the Incentive Program are transparent and flow

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& Daniel G. Weaver, The Value of the Specialist: Empirical Evidence from the CBOE, 9 J. FIN. MKTS. 100, 102–04 (2006); Rafi Eldor et al., The Contribution of Market Makers to Liquidity and Efficiency of Options Trading in Electronic Markets, 30 J. BANKING & FIN. 2025, 2025, 2029–31 (2006); M. Nimalendran & Giovanni Petrella, Do Thinly-Traded Stocks Benefit from Specialist Intervention?, 27 J. BANKING & FIN. 1823, 1829–30, 1851–52 (2003); Marios A. Panayides, Affirmative Obligations and Market Making with Inventory, 86 J. FIN. ECON. 513, 513 (2007); and Narayan Y. Naik & Pradeep K. Yadav, Trading Costs of Public Investors with Obligatory and Voluntary Market-Making: Evidence from Market Reforms 1, 17, 35 (Eur. Fin. Ass’n, Annual Conference Paper No. 408, 2003), available at <http://ssrn.com/abstract=424982>.

<sup>70</sup> See Dolgopolov Letter, supra note 5, at 5.

<sup>71</sup> See Dolgopolov Letter, supra note 5, at 2, citing the following studies: Kumar Venkataraman & Andrew C. Waisburd, The Value of the Designated Market Maker, 42 J. FIN. & QUANT. ANALYSIS 735 (2007); Kalman J. Cohen et al., The Impact of Designated Market Makers on Security Prices, 1 J. BANKING & FIN. 219, 245 (1977); Jennifer Huang & Jiang Wang, Market Liquidity, Asset Prices, and Welfare, 95 J. FIN. ECON. 107, 109 (2010); Wen Mao & Michael S. Pagano, Specialists as Risk Managers: The Competition Between Intermediated and Non-Intermediated Markets, 35 J. BANKING & FIN. 51, 64 (2011); and Johannes A. Skjeltorp & Bernt Arne Ødegaard, Why Do Listed Firms Pay for Market Making in Their Own Stock? 16, 30 (May 2012) (unpublished manuscript) (on file with author), available at <http://ssrn.com/abstract=1944057>).

through and are monitored by the Exchange.<sup>72</sup> The commenter further states that the specificity of the eligibility criteria for LMMs in the proposal should mitigate the concern that having just one market maker participant in the Incentive Program would be detrimental to competition.<sup>73</sup> Similarly, this commenter recognizes that manipulation is a concern with respect to this proposal, but states that the administration and monitoring of the Incentive Program by the Exchange is a mitigating factor.<sup>74</sup>

### III. Discussion and Commission Findings

The Commission has carefully considered the proposed rule change, as modified by Amendment Nos. 1 and 2 thereto, and finds that the proposed rule change, as modified by Amendment Nos. 1 and 2 thereto, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to national securities exchanges. In particular, as discussed below, the Commission finds that the proposed rule change is consistent with Section 6(b)(4) of the Act,<sup>75</sup> which requires that the rules of a national securities exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities, and with Section 6(b)(5) of the Act,<sup>76</sup> which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest, and that the rules not be designed to permit unfair discrimination between customers, issuers,

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<sup>72</sup> Id. at 2-3.

<sup>73</sup> Id. at 4.

<sup>74</sup> Id. at 4-5.

<sup>75</sup> 15 U.S.C. 78f(b)(4).

<sup>76</sup> 15 U.S.C. 78f(b)(5).

brokers, or dealers. Further, as required by Section 3(f) of the Act, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation.<sup>77</sup>

The Incentive Program, as proposed to be implemented on a pilot basis, is designed to enhance the market quality for certain lower volume ETPs participating in the program by incentivizing Market Makers to take LMM assignments in such ETPs by offering an alternative fee structure for such LMMs. As proposed by the Exchange, to be eligible to receive quarterly LMM Payments, an LMM participating in the program will be required to comply with the Incentive Program LMM Performance Standards, which are higher than the standard quoting requirements applicable to Market Makers on the Exchange. Specifically, in addition to satisfying the requirements of NYSE Arca Equities Rule 7.23, and subject to certain exceptions as further described above, an LMM participating in the program will be required to comply with the Market-Wide Requirement, and also with either the Time-at-the-Inside Requirement or the Size-Setting NBBO Requirement. In addition, an LMM participating in the Incentive Program must quote at least 2,500 shares of attributable, displayed liquidity within 2% of the NBB or NBO 90% of the time during Core Trading Hours. An LMM will receive an LMM Payment in an amount not to exceed 1/3 of the quarterly Optional Incentive Fee, less an Exchange administration fee of 5%, for each month the LMM meets or exceeds these heightened performance standards. Thus, the proposal is designed to incentivize LMMs participating in the Incentive Program to quote more often, and in greater quoted size, at the NBBO by conditioning the LMM Payment on whether an LMM meets or exceeds the Incentive Program LMM Performance Standards, including the Market-Wide Requirement, the Time-at-the Inside Requirement or, alternatively, the Size-Setting NBBO Requirement, and the additional

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<sup>77</sup> See 15 U.S.C. 78c(f).

requirement that an LMM must quote at least 2,500 shares of attributable, displayed liquidity within 2% of the NBB or NBO 90% of the time during Core Trading Hours. As a result, the proposal has the potential to improve the market quality of the ETPs that participate in the Incentive Program by encouraging LMMs to provide liquidity in such ETPs consistent with the Incentive Program LMM Performance Standards.<sup>78</sup> This potential improved market quality, were it to occur, could benefit investors in the form of enhanced liquidity, narrowed spreads, and reduced transaction costs.

In addition, because the quoted bid-ask spread in a security represents one of the main drivers of transaction costs for investors, and because high price volatility should generally deter investors from trading low-liquidity ETPs, the Incentive Program, were the potential benefits of the program to occur, should facilitate a more-efficient and less-uncertain trading environment for investors.<sup>79</sup> Furthermore, were the potential benefits of the Incentive Program to occur,

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<sup>78</sup> The Exchange states that when there is an LMM assigned to a security listed on NYSE Arca, long-term investors trading on the Exchange in the secondary market likely experience enhanced market quality compared to similar securities for which there are no LMMs assigned. See Notice, supra note 4, at 21683. The Exchange further states that in the fourth quarter of 2012, there were 609 ETPs listed on NYSE Arca that traded less than 10,000 shares CADV, and of those ETPs, 567 had LMMs while 42 did not, and the average spread for the ETPs with LMMs was 0.79% and the average quote size was 3,014 shares, while the average spread for the ETPs without LMMs was 11.52% and the average quote size was 1,655 shares. Id. In addition, the Exchange states that during the same time period, there were 410 ETPs listed on NYSE Arca that traded between 10,000 shares and 100,000 shares CADV, and of those ETPs, 396 had LMMs while 14 did not, and the average spread for the ETPs with LMMs was 0.23% and the average quote size was 6,643 shares, while the average spread for ETPs without LMMs was 0.36% and the average quote size was 2,613 shares. Id. The Exchange maintains that these observations are consistent over longer time periods and that there has been a greater variance in market quality for ETPs without LMMs. Id. at 21683-4.

<sup>79</sup> Transaction costs are generally defined as the penalty that an investor pays for transacting. Transaction costs have four components: commissions; bid/ask spread; market impact; and opportunity cost. See Grinold, Kahn. Active Portfolio Management, Second Edition, Chapter 16. An increase in bid-ask spreads will inevitably increase the transaction costs of an investor. In addition, transactions in low-liquidity securities have

improving the liquidity of certain low-volume ETPs may lead to both an overall increase in ETP trading volume and a redistribution of trading volume toward lower-volume ETPs that would not otherwise attract sufficient liquidity to successfully participate in the market.

While the Commission believes that the Incentive Program has the potential to improve market quality of the ETPs participating in the program, the Commission is concerned about unintended consequences of the Incentive Program. For example, the Incentive Program could have the potential to distort market forces because the Incentive Program may act to artificially influence trading in ETPs that otherwise would not be traded. Similarly, the Commission recognizes concerns about the potential negative impact on an ETP participating in the program, such as reduced liquidity and wider spreads, when an ETP is withdrawn or terminated from the Incentive Program. While the Commission is mindful of these concerns, the Commission believes, for the reasons described below, that certain aspects of the Incentive Program could help mitigate these concerns.

First, the proposal contains disclosure provisions that will help to alert and educate potential and existing investors in the ETPs participating in the Program about the program. Specifically, the Exchange will disclose on its website the following information: (i) the ETPs participating in the Incentive Program and the LMM assigned to each participating ETP; (ii) the date a particular ETP begins participating or ceases participating in the Incentive Program; (iii) the date the Exchange receives written notice of an issuer's intent to withdraw its ETP from the

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a higher market impact when compared to other more liquid securities. See Albert Kyle's (1985) measure of market impact (Kyle's Lambda), defining an inverse relationship between volume and price impact. Therefore, the lower the volume of the ETP or stock, the higher the market impact of any transaction in that stock. This last effect acts as a disincentive to trading that security. Therefore, an environment where an ETP trades more often and with a larger number of shares will reduce transaction costs both through the narrowing of spreads and lower market impact.

Incentive Program, or an LMM's intent to withdraw from its ETP assignment(s) in the Incentive Program, and, in each case, the intended withdrawal date, if provided; and (iii) the amount of the Optional Incentive Fee for each ETP. The Exchange also will include on its website a fair and balanced description of the Incentive Program, including a description of the potential benefits and risks that may be attendant with an ETP's participation in the program. Furthermore, an issuer of an ETP that is approved to participate in the Incentive Program will be required to issue a press release to the public when an ETP commences or ceases participation in the Incentive Program, to post such press release on its website, and to provide on its website a hyperlink to the Exchange's webpage describing the Incentive Program. This disclosure will help to inform investors and other market participants which ETPs are participating in the Incentive Program, which LMMs are assigned to each ETP, the amount of Optional Incentive Fee an issuer will incur as a result of participating in the Incentive Program, the maximum amount of LMM Payments an LMM could potentially receive from the Exchange under the Incentive Program, and the potential benefits and risks of the program. A wide variety of ETPs are currently listed and trading today, and the Commission believes that such disclosure could be helpful for investors and other market participants to discern which ETPs listed on the Exchange are and are not subject to the Incentive Program and to make informed investment decisions with respect to ETPs.<sup>80</sup>

Second, the Incentive Program is targeted at a subset of ETPs, namely those ETPs that are generally less liquid and which the Exchange believes might benefit most from the Incentive Program. Specifically, as proposed, ETPs that are otherwise eligible for the Incentive Program

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<sup>80</sup> The concurrent exemptive relief the Commission is issuing today from Rule 102 under Regulation M concerning the Incentive Program also contains additional disclosure requirements. See Securities Exchange Act Release No. 69707 (June 6, 2013), supra note 7.

will not be eligible if they have a CADV of more than 1,000,000 shares for three consecutive months. Likewise, the Incentive Program will terminate with respect to a particular ETP if the ETP sustains a CADV of 1,000,000 shares or more for three consecutive months.

Finally, as proposed by the Exchange, the Incentive Program will be limited to a one-year pilot. The Commission believes that it is important to implement the Incentive Program as a pilot. Operating the Incentive Program as a pilot will allow assessment of whether the Incentive Program is in fact achieving its goal of improving the market quality of ETPs by incentivizing Market Makers to take LMM assignments, prior to any proposal or determination to make the program permanent.<sup>81</sup> In addition, approval on a pilot basis will allow the assessment, prior to any proposal or determination to make the program permanent, of whether the Incentive Program has any unintended impact on the participating ETPs, securities not participating in the program, or the market or market participants generally.

The Exchange has represented that during the pilot it will submit monthly reports to the Commission about market quality in respect of the Incentive Program and that these reports will be posted on the Exchange's public website. The Exchange has represented that such reports will include the Exchange's analysis regarding the Incentive Program and whether it is achieving its goals, as well as market quality data for all ETPs listed as of the date of implementation of the Incentive Program and listed during the pilot period (for comparative purposes, including comparable ETPs that are listed on the Exchange but not participating in the Incentive Program) such as volume (CADV and NYSE Arca average daily volume), NBBO bid/ask spread

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<sup>81</sup> The Exchange would be required to file with the Commission any proposal to extend the Incentive Program beyond the pilot period or to make the program permanent pursuant to Section 19(b) of the Exchange Act and the rules and regulations thereunder. Such a filing would be published for comment in the Federal Register pursuant to Section 19(b) and Rule 19b-4.

differentials, LMM participation rates, NYSE Arca market share, LMM time spent at the inside, LMM time spent within \$0.03 of the inside, percent of time NYSE Arca had the best price with the best size, LMM quoted spread, LMM quoted depth, and Rule 605 statistics (one-month delay). In addition, the Exchange has represented that it will provide in the monthly public report to the Commission data and analysis on the market quality of ETPs after they exceed the one million CADV threshold and “graduate” from the program or are otherwise withdrawn or terminated from the program. The Exchange also has represented that it will provide to the Commission and any other data and information related to the Incentive Program as may be periodically requested by the Commission in connection with the proposal. In addition, the Exchange has represented that issuers may utilize ArcaVision to analyze and replicate data on their own.<sup>82</sup> This information will help the Commission, the Exchange, and other interested persons to evaluate whether the Incentive Program has resulted in the intended benefits it is designed to achieve, any unintended consequences resulting from the Incentive Program, and the extent to which the Incentive Program alleviates or aggravates the concerns the Commission has noted, including previously-stated Commission concerns relating to issuer payments to market makers.<sup>83</sup>

For example, the Exchange and the Commission will look to assess what impact, if any, there is on the market quality of ETPs that withdraw or are otherwise terminated from the Incentive Program. One way for an ETP to be terminated from the Incentive Program is if it exceeds the 1,000,000 CADV threshold included within the rules.<sup>84</sup> The Commission recognizes that the Incentive Program may not, in the one-year pilot period, produce sufficient data (i.e., a

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<sup>82</sup> See supra note 59 and accompanying text.

<sup>83</sup> See infra notes 86-89 and accompanying text.

<sup>84</sup> See proposed NYSE Arca Equities Rule 8.800(e)(4).

large number of ETPs that enter and exit the Incentive Program) to allow a full assessment of whether termination (or withdrawal) of an ETP from the program has resulted in any unintended consequences on the market quality of the ETP or otherwise. However, the Commission believes that the proposal strikes a reasonable balance between (i) setting the threshold for “graduation” from the Incentive Program high enough to encourage participation in the program and (ii) setting the threshold low enough to have a sufficient number of ETPs graduate from the Incentive Program within the pilot period so that the Exchange, the Commission, and other interested persons can assess the impact, if any, of the Incentive Program, including “graduation” of ETPs from the program.

Furthermore, the pilot structure of the Incentive Program will provide information to help determine whether any provisions of the Incentive Program should be modified. For example, based on data from the pilot, the Exchange may determine that the 1,000,000 CADV termination threshold is not an appropriate threshold on which to base eligibility for the program or that the program should be time-limited.

The Commission believes that the design of the Incentive Program and the public disclosure requirements, coupled with implementation of the proposal on a pilot basis, should help mitigate potential concerns the Commission has noted above relating to any unintended or negative effects of the Incentive Program on the ETP market and investors.

The Commission has previously expressed concerns relating to payments by issuers to market makers. Financial Industry Regulatory Authority (“FINRA”) Rule 5250 (formerly NASD Rule 2460) prohibits FINRA members and their associated persons from directly or

indirectly accepting any payment from an issuer for acting as a market maker.<sup>85</sup> FINRA Rule 5250 was implemented, in part, to address concerns about issuers paying market makers, directly or indirectly, to improperly influence the price of an issuer's stock and because of conflict of interest concerns between issuers and market makers.<sup>86</sup> FINRA Rule 5250 was designed to preserve "the integrity of the marketplace by ensuring that quotations accurately reflect a broker-dealer's interest in buying or selling a security."<sup>87</sup> Specifically, in the NASD Rule 2460 Approval Order, the Commission found that 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."<sup>88</sup>

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<sup>85</sup> FINRA has amended Rule 5250 to create an exception for payments to members that are expressly provided for under the rules of a national securities exchange that are effective after being filed with, or filed with and approved by, the Commission pursuant to the requirements of the Act. See Securities Exchange Act Release No. 69398 (Apr. 18, 2013), 78 FR 24261 (Apr. 24, 2013). This amendment to FINRA Rule 5250 became effective May 15, 2013.

<sup>86</sup> See Securities Exchange Act Release No. 38812 (July 3, 1997), 62 FR 37105 (July 10, 1997) (SR-NASD-97-29) ("NASD Rule 2460 Approval Order"), at 37107.

<sup>87</sup> See id. at 37107.

<sup>88</sup> See id.

The Commission also added that “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.”<sup>89</sup>

The Commission believes that a number of aspects of the Incentive Program mitigate the concerns that FINRA Rule 5250 was designed to address. First, the Commission believes that the terms of the Incentive Program are generally objective, clear, and transparent. The standards for the Incentive Program are set forth in proposed NYSE Arca Equities Rule 8.800 and the Exchange’s Listing Fee Schedule and Trading Fee Schedule (further described above)<sup>90</sup> and describe the ETP eligibility criteria, application and assignment process, fee and payment structure, performance standards that an LMM must meet and maintain to secure an LMM Payment, withdrawal and termination standards, and LMM reallocation process. These requirements apply to all ETPs, issuers, and LMMs participating in the Incentive Program.

Second, the Exchange also will provide notification on its public website regarding the various aspects of the Incentive Program. As discussed above, this disclosure will include: (i) the ETPs participating in the Incentive Program and the LMM assigned to each participating ETP; (ii) the date a particular ETP begins participating or ceases participating in the Incentive Program; (iii) the date the Exchange receives written notice of an issuer’s intent to withdraw its ETP from the Incentive Program, or an LMM’s intent to withdraw from its ETP assignment(s) in the Incentive Program, and, in each case, the intended withdrawal date, if provided; (iv) the amount of the Optional Incentive Fee for each ETP; and (v) a fair and balanced description of the Incentive Program, including the potential benefits and risks that may be attendant with an ETP’s participation in the program. In addition, an issuer of an ETP participating in the Incentive

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<sup>89</sup> See id. at 37106.

<sup>90</sup> See supra Section I.

Program will be required to issue a press release when an ETP commences or ceases participation in the Incentive Program, to post such press release on its website, and to provide on its website a hyperlink to the Exchange's webpage describing the Incentive Program.

And third, ETPs participating in the Incentive Program will be traded on the Exchange, which is a regulated market, pursuant to the current trading and reporting rules of the Exchange, and pursuant to the Exchange's established market surveillance and trade monitoring procedures. The Exchange will administer the application and acceptance of the ETPs and LMMs into the Incentive Program and will manage the payment of the LMM Payment to LMMs from the Exchange's general revenues. An LMM would not be entitled to an LMM Payment unless and until it meets or exceeds the Incentive Program LMM Performance standards for an assigned ETP, as determined by the Exchange. The Exchange has represented that the Exchange will be responsible for assigning LMMs to particular ETPs, and an issuer's preference will not be determinative. Furthermore, the Optional Incentive Fees will be paid into the Exchange's general revenues, and the LMM Payments will be paid out of the Exchange's general revenues. If an LMM does not meet the Incentive Program LMM Performance Standards for an ETP for a given month, the issuer will not receive any refund or credit from the Exchange. If an issuer does not pay its quarterly installment of the Optional Incentive Fee for a particular ETP to the Exchange on time, the Exchange will continue to credit the LMM for LMM Payments as long as the LMM meets the Incentive Program LMM Performance Standards. The Commission believes that these factors, taken together, should help to mitigate the conflict of interest and other concerns that the Commission has previously identified<sup>91</sup> relating to issuers paying for market making.<sup>92</sup>

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<sup>91</sup> See NASD Rule 2460 Approval Order, supra note 86, and supra notes 86-89. See also

The Commission believes that it is reasonable and consistent with the Act for the Exchange to limit the Incentive Program to certain types of securities to allow the Exchange, through a pilot, to assess whether the program will have the desired effect of improving the market quality of these securities before implementing the program on a permanent basis. The Commission believes that it is reasonable and consistent with the Act for the Exchange to limit the Incentive Program to products under the 1,000,000 CADV threshold, to support the Exchange's stated purpose to "support the provision of consistent liquidity in lower-volume ETPs listed on the Exchange."<sup>93</sup>

The Commission believes that the Optional Incentive Fees are an equitable allocation of reasonable fees. First, participation in the Incentive Program is voluntary. An entity is free to determine whether it would be economically desirable to pay the Optional Incentive Fee, given the permitted range of the fee, the trading characteristics of the ETP, and the anticipated benefit.

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Securities Act Release No. 6334 (Aug. 6, 1981), 46 FR 42001 (Aug. 18, 1981), at Section IV.B (Treatment as Statutory Underwriter). The Exchange notes that the derivative and open-ended nature of many of the ETPs eligible to participate in the Incentive Program would allow for transparent intrinsic intraday pricing and, as such, the Exchange does not believe such products would lend themselves to the type of market manipulation that FINRA Rule 5250 was designed to prevent. See Notice, supra note 4, at 21688-9.

<sup>92</sup> Until the amendment to FINRA Rule 5250 to exempt payments made pursuant to the rules of a national securities exchange from the prohibition on payments by issuers to market makers under FINRA Rule 5250 becomes effective, receipt of payments pursuant to the Incentive Program by an LMM that is a FINRA member would be in violation of FINRA Rule 5250. See supra note 85.

<sup>93</sup> See Notice, supra note 4, at 21688. In addition, under the proposal an issuer would not be permitted to have more than five existing ETPs (i.e., ETPs that are listed on the Exchange prior to the pilot) participate in the Incentive Program. The Commission believes that it is reasonable and consistent with the Act for the Exchange to limit the number of existing ETPs per issuer that may participate in the Incentive Program during the pilot period, as all issuers participating in the program will be subject to this limit. Furthermore, such limit should allow for the analysis of the impact of the Fixed Incentive Program during the pilot on eligible ETPs participating and not participating in the program, as the number of those existing eligible ETPs that may participate in the program will be limited.

If an issuer chooses to participate in the Incentive Program with respect to an ETP, it will have the discretion to designate the amount of the Optional Incentive Fee it will pay, between \$10,000 and \$40,000. The Optional Incentive Fees will be paid for by either the issuer that has an ETP participating in the Incentive Program or the sponsor associated with such issuer. Thus, the Optional Incentive Fee will be incurred and paid for by an entity that has chosen to participate in, and that may potentially benefit from, the Incentive Program.<sup>94</sup> An entity that chooses not to participate will not be required to pay any additional fee beyond the standard listing and annual fees. Further, the permitted range of Optional Incentive Fees will be the same for any issuer wishing to participate in the program.

The Commission also believes that allowing the issuer some discretion when determining the amount of the Optional Incentive Fee amount is consistent with the Act. Not all ETPs are alike, and trading in certain products may be riskier or more costly than trading in others. The Commission believes that it is reasonable to allow each issuer to choose to participate in the program and to determine the amount, subject to a permitted range, at which it is desirable to

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<sup>94</sup> Issuers of exchange-traded funds registered under the 1940 Act are prohibited from paying directly or indirectly for distribution of their shares (*i.e.*, directly or indirectly financing any activity that is primarily intended to result in the sale of shares), unless such payments are made pursuant to a plan that meets the requirements of Rule 12b-1 under the 1940 Act. Although the services at issue could be primarily intended to result in the sale of fund shares, the Commission has stated that such a determination will depend on the surrounding circumstances. See Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431 (June 13, 1988) (“1988 12b-1 Release”). As the Commission has noted previously, if a fund makes payments that are ostensibly for a non-distribution purpose, and the recipient of those payments finances distribution, the question arises whether the fund’s assets are being used indirectly for distribution. The Commission has stated that there can be no precise definition of what types of expenditures constitute indirect use of fund assets, and this determination is based on the facts and circumstances of each individual case. In addition, fund directors, particularly independent directors bear substantial responsibility for making that judgment. See Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (October 28, 1980).

incentivize LMMs through the Optional Incentive Fee to improve the market quality of ETPs participating in the program. Further, as discussed above, the payment of the Optional Incentive Fee will be transparent to the marketplace, as this information will be disclosed on the Exchange’s website.

#### IV. Section 11(d)(1) of the Exchange Act

Section 11(d)(1) of the Exchange Act<sup>95</sup> generally prohibits a broker-dealer from extending or maintaining credit, or arranging for the extension or maintenance of credit, on shares of new issue securities, if the broker-dealer participated in the distribution of the new issue securities within the preceding 30 days. The Commission’s view is that shares of open-end investment companies and unit investment trusts registered under the 1940 Act, such as ETP shares, are distributed in a continuous manner, and broker-dealers that sell such securities are therefore participating in the “distribution” of a new issue for purposes of Section 11(d)(1).<sup>96</sup>

The Division of Trading and Markets, acting under delegated authority, granted an exemption from Section 11(d)(1) and Rule 11d1-2 thereunder for broker-dealers that have entered into an agreement with an exchange-traded fund’s distributor to place orders with the distributor to purchase or redeem the exchange-traded fund’s shares (“Broker-Dealer APs”).<sup>97</sup> The SIA Exemption allows a Broker-Dealer AP to extend or maintain credit, or arrange for the extension or maintenance of credit, to or for customers on the shares of qualifying exchange-traded funds subject to the condition that neither the Broker-Dealer AP, nor any natural person

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<sup>95</sup> 15 U.S.C. 78k(d)(1)

<sup>96</sup> See, e.g., Exchange Act Release Nos. 6726 (Feb. 8, 1962), 27 FR 1415 (Feb. 15, 1962) and 21577 (Dec. 18, 1984), 49 FR 50174 (Dec. 27, 1984).

<sup>97</sup> See Letter from Catherine McGuire, Chief Counsel, Division of Trading and Markets, Securities and Exchange Commission to Securities Industry Association (Nov. 21, 2005) (“SIA Exemption”).

associated with the Broker-Dealer AP, directly or indirectly (including through any affiliate of the Broker-Dealer AP), receives from the fund complex any payment, compensation, or other economic incentive to promote or sell the shares of the exchange-traded fund to persons outside the fund complex, other than non-cash compensation permitted under NASD Rule 2830(1)(5)(A), (B), or (C). This condition is intended to eliminate special incentives that Broker-Dealer APs and their associated persons might otherwise have to “push” exchange-traded fund shares.<sup>98</sup>

The Incentive Program will permit certain ETPs to voluntarily incur increased listing fees payable to the Exchange. In turn, the Exchange will use the fees to make incentive payments to market makers that improve the liquidity of participating issuers’ securities, and thus enhance the market quality for the participating issuers. Incentive payments will be accrued for, among other things, executing purchases and sales on the Exchange. Receipt of the incentive payments by certain broker-dealers will implicate the conditions of the SIA Exemption<sup>99</sup> from the new issue lending restriction in Section 11(d)(1) of the Exchange Act discussed above. The Commission’s view is that the incentive payments market makers will receive under the proposal are indirect payments from the fund complex to the market maker and that those payments are compensation to promote or sell the shares of the ETP. Therefore, a market maker that is also a

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<sup>98</sup> Trading and markets staff provided no-action relief from Section 11(d)(1) for broker-dealers engaging in secondary market proprietary or customer transactions in securities of Commodity-based Exchange-Traded Trusts (“CBETTs”) similar to the Commission’s SIA Exemption. This relief is conditioned on the broker-dealer and any natural person associated with the broker-dealer not receiving from the Fund complex, directly or indirectly, any payment, compensation or other economic incentive to promote or sell Shares to persons outside of the Fund complex, other than non-cash compensation permitted under NASD Rule 2830(1)(5)(A), (B), or (C). See No-Action Letter re: DB Commodity Index Tracking Fund and DB Commodity Services LLC (Jan. 19, 2006); No-Action Letter re: Rydex Specialized Products LLC (Dec. 5, 2005); No-Action Letter re: streetTRACKS Gold Trust (Dec. 12, 2005); and No-Action Letter re: iShares COMEX Gold Trust (Dec. 12, 2005).

<sup>99</sup> See also note 98, *supra*.

broker-dealer receiving the incentives will not be able to rely on the SIA Exemption from Section 11(d)(1).<sup>100</sup> This does not mean that broker-dealers cannot participate in the Incentive Program; it merely means they cannot rely on the SIA Exemption<sup>101</sup> while doing so. Thus, broker-dealers that participate in the Incentive Program will need to comply with Section 11(d)(1) unless there is another applicable exemption.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>102</sup> that the proposed rule change (SR-NYSEArca-2013-34), as modified by Amendment Nos. 1 and 2 thereto, be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>103</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>100</sup>

Id.

<sup>101</sup>

Id.

<sup>102</sup>

15 U.S.C. 78s(b)(2).

<sup>103</sup>

17 CFR 200.30-3(a)(12).