

February 1, 2018

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Submitted via email: pubcom@finra.org

Re: FINRA Retrospective Rule Review on the Effectiveness and Efficiency of Its Payments for Market Making Rule (FINRA Rule 5250); Regulatory Notice 17-41

Dear Ms. Mitchell:

State Street Global Advisors (SSGA) welcomes the opportunity to submit this letter in response to Financial Industry Regulatory Authority (FINRA) Regulatory Notice 17-41 requesting comment on the effectiveness and efficiency of FINRA Rule 5250 (Payments for Market Making). SSGA is a leading fund manager and issuer of the SPDRs family of exchange-traded funds (ETFs). Consequently, we support and encourage initiatives that promote efficient and well-functioning markets where clients can execute investment decisions with confidence. SSGA manages 247 ETFs globally with \$728 billion in AUM, including 134 US-listed ETFs with \$676 billion in AUM.¹ In 2017, SSGA's US-listed ETFs constituted 10.3% of value traded in the US equity market.²

SSGA believes FINRA Rule 5250 provides important protections for investors, and any consideration for changes to the rule should clearly improve market quality and protect the interests of investors. While the current rule allows some latitude for issuer payment through exchange programs, in recent months, some market participants have advocated expanding the rule's exemptions to permit payment from Exchange-Traded Product (ETP) issuers to market makers, even outside of exchange programs.³ Some have argued that exempting ETPs from Rule 5250 could benefit the US ETP marketplace without introducing the conflicts of interest that the rule intends to mitigate. We agree that arbitrage opportunities and incentives to minimize tracking error can mitigate concerns about the potential for ETP issuer payment to influence prices improperly. We also recognize the challenges associated with supporting market quality in ETPs, and we acknowledge that payment is one way in which ETP issuers could incentivize market maker support.

When we consider the practical implications of an ETP exemption and how it may play out in the US marketplace, however, we fear unintended consequences arising from the likelihood that issuer payment to market makers would become conventional. The ripple effects, which may not be obvious on the surface, could actually undermine some of the reasons firms have given for amending the rule. This leads to two fundamental questions: (i) what problem is an ETP exemption meant to solve?; and (ii) would the change benefit investors?

¹ Based on data from Bloomberg as of January 29, 2018.

² Based on volume data from January 1, 2017 through December 31, 2017 as calculated and published by Bloomberg. The SPDR S&P 500 ETF Trust (SPY) constituted 6.35% of US equity market value traded in 2017.

³ See Letter from Chris Concannon, President and COO, Cboe Global Markets, to FINRA (November 22, 2017), available at http://www.finra.org/sites/default/files/notice_comment_file_ref/17-41_Concannon_Comment.pdf; Letter from Douglas Cifu, Chief Executive Officer, Virtu Financial, to FINRA (January 3, 2018), available at http://www.finra.org/sites/default/files/notice_comment_file_ref/17-41_virtu_comment.pdf.

Rule 5250 Background

FINRA's prohibition on issuer payment to market makers was originally set forth in 1975 (Notice to Members 75-16) and was codified as NASD Rule 2460 in 1997 (currently FINRA Rule 5250). The rule was implemented, in part, to address concerns about issuers paying market makers, directly or indirectly, to influence the price of an issuer's stock improperly and also because of unavoidable conflicts of interest between issuers and market makers.⁴ 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."⁵ Specifically, in the NASD Rule 2460 Approval Order in 1997, the SEC 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."⁶

2013 Amendment and Issuer-Funded Exchange Programs

In 2013, FINRA amended Rule 5250 to provide an exemption for issuer payments to market makers that are addressed in the rules of a national securities exchange that are effective after being filed with the SEC pursuant to the requirements of the Securities Exchange Act.⁷ The amendment coincided with the introduction of two exchange pilot programs that sought to incentivize market makers to improve market quality in lower-volume ETPs⁸ through payments that were funded by ETP issuers.

The SEC approved the following exchange pilot programs that year:

- *Nasdaq's Market Quality Program (MQP)* provided for ETP issuer payments between \$50,000 and \$100,000 per security per year. Market makers who met specific quoting obligations were eligible to compete for a pro rata share of the payments, which Nasdaq awarded to market makers based on measures of quote quality and share of liquidity-providing executions.⁹
- *NYSE Arca's ETP Incentive Program* provided for ETP issuer payments between \$10,000 and \$40,000 per security per year. Market makers who undertook Lead Market Maker (LMM) assignments in these securities and thereby committed to specific quoting obligations were entitled to receive a fixed payment. NYSE Arca retained a 5% administrative fee.¹⁰

⁴ See Securities Exchange Act Release No. 38812 (July 3, 1997), Order Granting Approval to Proposed Rule Change Relating to Prohibition on Members Receiving Payment for Market Making, *available at* <https://www.gpo.gov/fdsys/pkg/FR-1997-07-10/html/97-18090.htm>.

⁵ *Ibid.*

⁶ *Ibid.*

⁷ See Securities Exchange Act Release No. 69398 (April 18, 2013), Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to FINRA Rule 5250 (Payments for Market Making), *available at* <https://www.sec.gov/rules/sro/finra/2013/34-69398.pdf>.

⁸ The programs were limited to ETPs with consolidated average daily volume of ≤ 1 million shares.

⁹ See Securities Exchange Act Release No. 69195 (March 20, 2013), Order Granting Approval of a Proposed Rule Change to Establish the Nasdaq Market Quality Program, *available at* <https://www.sec.gov/rules/sro/nasdaq/2013/34-69195.pdf>.

¹⁰ See Securities Exchange Act Release No. 69706 (June 6, 2013), Order Granting Approval of a Proposed Rule Change to Implement a One-Year Pilot Program for Issuers of Certain ETPs Listed on NYSE Arca Inc., *available at* <https://www.sec.gov/rules/sro/nysearca/2013/34-69706.pdf>.

These pilot programs differed from methods conventionally employed by exchanges to incentivize liquidity provision. Traditionally, exchanges have given preferential transaction fee schedules to market makers who commit to enhanced quoting obligations. For example, on NYSE Arca, market makers who commit to minimum performance requirements and undertake Lead Market Maker (LMM) assignments in NYSE Arca-listed securities are compensated with higher transaction rebates and incur lower transaction fees compared to standard maker-taker rates.¹¹ Similarly, on Nasdaq, market makers who qualify as Designated Liquidity Providers (DLPs) by maintaining higher standards of liquidity in Nasdaq-listed ETPs are eligible for enhanced rebates when trading Nasdaq-listed ETPs.¹²

It has been noted that because traditional incentives are generally realized on a per-transaction basis, they may not justify market makers supporting lower-volume securities.¹³ The pilot programs introduced in 2013 gave ETP issuers an option to increase market maker incentives beyond what was otherwise offered by the exchanges through traditional means.¹⁴ While the issuer-funded pilot programs applied to lower-volume ETPs only, it was anticipated that if the programs were successful, exchanges would eventually seek expansion to small cap stocks and other products that could benefit from liquidity enhancement.¹⁵

The exchange pilot programs operated for a few years, but utilization of the programs by ETP issuers was limited, and impacts were uncertain.^{16,17} Anecdotally, a few hypotheses about why the pilot programs did not achieve anticipated results have included:

- ETP issuers may not have felt a need to use the programs;
- ETP issuers may not have seen sufficient benefit to justify the cost of participating;
- ETP issuers may have decided to prioritize other expenses or initiatives;
- The incentive payment may not have been meaningful enough to affect market quality;
- The lack of certainty of payment (i.e. in the case of Nasdaq MQP) may have discouraged market makers from engaging.

There is opportunity to examine the pilot programs introduced under the 2013 exemption and evaluate why they failed to gain traction. A survey of ETP issuers as to their experience with the programs (and why they didn't utilize them in many cases) could help FINRA to evaluate the effectiveness of the exemption and the need for change.

¹¹ See NYSE Arca Lead Market Maker Program, available at <https://www.nyse.com/products/etp-funds-etf/lmm>.

¹² See Nasdaq Price List, available at <http://nasdaqtrader.com/Trader.aspx?id=PriceListTrading2>.

¹³ See House Hearing on Roadblocks in Public Markets (November 15, 2011), available at <https://www.gpo.gov/fdsys/pkg/CHRG-112hhrg73616/pdf/CHRG-112hhrg73616.pdf> (“[M]ost of that [incentive payment] is on a per-transaction basis and these issues don’t trade very frequently. It doesn’t generate enough revenue to necessarily incentivize the liquidity providers.”).

¹⁴ It is worth mentioning that in 2012, Bats Exchange Inc. introduced a market maker incentive program for low-volume ETPs that was similar to Nasdaq’s and NYSE Arca’s pilot programs in that market makers were paid based on quoting performance, but it differed in that the payments were not directly funded by ETP issuers. Designed in part to encourage ETP listings, it provides an example of how exchange competition has also resulted in innovative market quality incentive programs outside of the traditional methods. See Securities Exchange Act Release No. 66307 (February 2, 2012), available at <https://www.sec.gov/rules/sro/bats/2012/34-66307.pdf>; Securities Exchange Act Release No. 66427 (February 21, 2012), available at <https://www.sec.gov/rules/sro/bats/2012/34-66427.pdf>.

¹⁵ See *supra* note 9, p. 23 (“The Exchange [Nasdaq] has indicated that if the MQP is successful, it will seek to expand the program to small cap stocks and other similar products that may need liquidity enhancement.”); See *supra* note 13 (“[A]ssuming we [NYSE] can document positive results [of an ETP issuer-funded liquidity incentive program], we can then try a second experiment with some stocks and see if it has the same effect.”).

¹⁶ See Assessment Report for NYSE Arca Incentive Program (April 28, 2017), available at https://www.nyse.com/publicdocs/nyse/products/etp-funds/ETP_Incentive_Program_Assessment_Report.pdf (“[T]he Exchange is not able to provide conclusive evidence that the Incentive Program has met its objectives during the pilot period... given the limited number of products in the program and, thus, the limited amount of data on which the analysis is based... [T]he last product exited the program on 7/1/2016.”).

¹⁷ SSGA has not utilized the exchange pilot programs as of the date of writing.

Current Topic: Should ETPs be Exempt from Rule 5250?

Some market participants are suggesting Rule 5250 be modified to allow ETP issuer payments to market makers outside the context of an exchange program.¹⁸ On the surface, the suggestion to exempt ETPs from Rule 5250 seems logical, and could have some benefits, but the unintended consequences of such an exemption in the marketplace necessitates a judicious consideration of the negatives as well. A decision to exempt ETPs from Rule 5250 would need to weigh the potential pros and cons.

I. Positives

We agree with certain points that have been made in comment letters advocating for ETP issuer payment to lead market makers. Specifically:

- *Rule 5250 concerns are less relevant for ETPs* – As others have argued, since ETP prices are generally linked back to the underlying constituents, ETPs are impervious to the main concerns that Rule 5250 is intended to mitigate.¹⁹ As Cboe's letter highlights, the ability for market participants to engage in arbitrage provides a "means and economic incentive to bring [an] ETP's price back in line with the Indicative Value regardless of whether certain of the trading activity in the ETP is illusory."²⁰ It is assumed that ETP issuer payment to market makers would support benefits like market quality, liquidity provision, and efficient price tracking.
- *Issuer payment could promote market quality* – Exempting ETPs from Rule 5250 could give ETP issuers a means to secure a lead market maker and improve secondary market quality in their funds. With the anticipation of more actively managed funds and fixed income funds adopting the ETP structure, there is significant potential for continued growth in the number of ETP issuers and number of funds. Yet as the industry has matured and costs of capital have increased, the runway for launching new products has become bumpier, making it more difficult for new entrants to obtain market maker support.²¹ Additionally, there are many existing ETPs with low volume where it is more challenging for lead market makers to manage inventory. In these cases, direct payment could help an ETP issuer to secure a lead market maker.

II. Considerations

While issuer payment may help resolve a narrow segment of present difficulties, that focus is too limited. The question of opening the door to issuer payment must be examined as a whole to consider the long-term ramifications for investors. The potential for issuer payment to market makers becoming standard practice in the marketplace brings home the

¹⁸ See Bloomberg, *Many ETFs Languish. Virtu Wants to Get Paid to Help Fix That*, October 18, 2017, available at <https://www.bloomberg.com/news/articles/2017-10-18/many-etfs-languish-virtu-wants-to-get-paid-to-help-fix-that>; See Letter from Chris Concannon, President and COO, Cboe Global Markets, to FINRA (November 22, 2017), available at http://www.finra.org/sites/default/files/notice_comment_file_ref/17-41_Concannon_Comment.pdf.

¹⁹ The point has long been argued, including in 2013 with the adoption of the exchange's ETP issuer-funded pilot programs discussed previously. See, e.g., Securities Exchange Act Release No. 68515 (December 21, 2012) (Notice of Filing of a Proposed Rule Change to Establish the Nasdaq Market Quality Program), available at <https://www.sec.gov/rules/sro/nasdaq/2012/34-68515.pdf> ("[T]he 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.").

²⁰ See Letter from Chris Concannon, President and COO, Cboe Global Markets, to FINRA (November 22, 2017), available at http://www.finra.org/sites/default/files/notice_comment_file_ref/17-41_Concannon_Comment.pdf.

²¹ See Bloomberg, *'Count Us Out' Is Traders' Message to ETFs Seeking Startup Money*, October 20, 2017, available at <https://www.bloomberg.com/news/articles/2017-10-20/-count-us-out-is-traders-message-to-etfs-seeking-startup-money> ("[ETFs] once had little difficulty locating money to get off the ground [...] [H]obbled by regulations and mounting costs, the market makers that used to act as initial investors are increasingly telling issuers to look elsewhere for seed capital.").

phrase “be careful what you wish for.” Below are some of the questions and potential outcomes we foresee.

- *Higher costs and barriers to entry for issuers* – Issuer payment to market makers may create a “pay-to-play” environment for issuers, where suddenly payment is demanded in order to obtain a lead market maker. It may become necessary for ETP issuers to budget additional funds for entering into contracts with lead market makers to support new or thinly-traded ETPs, or even the issuer’s full range of ETPs. Here is the basic question: how much money are we talking about? Consider the following example: A new product has \$5 million in assets and a 10 basis point management fee, yielding \$5,000 in gross revenue. Even if 100% of the revenue were paid to a lead market maker, would this be enough? One could argue it is an attempt to solve a dollar problem with pennies. What problem would it solve?

While it has been suggested that allowing issuer payment to market makers could support “small, new funds,”²² ironically, the natural evolution is that competition among issuers, and the ability for large issuers with resources to pay larger sums, could drive up the cost of these contracts, ultimately raising barriers to entry for new products and smaller issuers. Although larger issuers such as SSGA could enjoy a competitive advantage in such a scenario, we worry about the ultimate impact on clients, and what it means for market quality in the long run. Resources that could be directed towards investors and improvements like product education and distribution, in an effort to drive demand, are instead diverted towards paying market makers in a “pay-to-play” scenario to remain competitive.

As a global asset manager, we face this challenge in other countries where issuer payment to market makers is the norm. In Europe, for example, entering into contracts with market makers has been necessary to compete. Distinctions in European market structure – where the same fund may be listed in multiple countries and could have different liquidity in each market – have rendered issuer contracts with market makers necessary, and it is a standard market practice there. We have not sought to replicate this environment in the US, where the market structure has promoted quote competition more naturally.

- *Higher costs for investors* – Should issuer payment to market makers become the market convention, the cost of developing and listing products would increase. These costs would need to be funded, and would likely show up in ETP expense ratios. This could reverse the trend toward lower expense ratios that investors have enjoyed in recent years. Considering that the total cost of ownership equals the management fee plus transaction costs, and payment to market makers could theoretically reduce the transaction cost only to shift cost towards the management fee, would investors actually be better off?
- *Market maker concentration* – If issuer payment is permitted, large issuers may be economically driven to concentrate contracts with a small number of market makers to ensure the payment is most efficient and meaningful.²³ Over time, concentration of paid market makers would likely generate ripple effects on market resilience as ETP issuers become solely dependent on a single or narrow subset of market makers that they pay. In contrast to this portent of shrinking opportunity, we prefer an environment where many liquidity providers are encouraged to compete to provide the best market quality. To this end, in the past year we

²² See Bloomberg, *Many ETFs Languish. Virtu Wants to Get Paid to Help Fix That*, October 18, 2017, available at <https://www.bloomberg.com/news/articles/2017-10-18/many-etfs-languish-virtu-wants-to-get-paid-to-help-fix-that> (“Along with New York-based Cantor Fitzgerald LP, another ETF market maker, Virtu argues that traders would be more inclined to support small, new funds if ETF issuers could pay them.”).

²³ To illustrate with a simple theoretical example, an issuer could have \$10 contracts with five market makers, or consolidate relationships and have a \$30 contract with one market maker.

undertook a significant project to diversify and distribute funds strategically amongst our lead market maker relationships.

- *Exclusive arrangements* – To the extent ETP issuers are driven to concentrate relationships where payment is most meaningful, it is easy to foresee anticompetitive behaviors developing as a consequence. Without proper oversight and transparency of agreement terms, an ETP issuer could be incentivized to enter into an anticompetitive, private contract with a lead market maker to prevent the market maker from providing services paid for by the ETP issuer to the issuer's competitors.
- *Investor confidence* – Issuer payments to market makers could harm investor confidence, despite the protections provided by the ETP structure. Consider the following scenario: an investor buys a thinly-traded ETP when the spread is penny-wide due to the issuer paying a market maker. The investor later discovers they need to exit the position after quotations have widened as a result of the issuer stopping payment to the market maker. If the investor had known from the beginning that the market quality was enhanced by a private compensation arrangement, would they have invested? This would create fertile ground in which to cultivate mistrust of the marketplace. One must also consider that while issuer contracts with market makers would be designed to promote market quality for the benefit of investors, there would be no guarantees that the hoped-for quality would continue in times of market stress.
- *Defining the problem* – We are led to the question: what problem is an ETP exemption from Rule 5250 meant to solve? If there are concerns about market quality deterioration in low-volume ETPs, a study could be performed to evaluate the issue and examine a range of reforms to address any problems identified, focusing on results that benefit investors. Some ideas that could be explored further, among others, include:
 - Revoking Unlisted Trading Privileges for exchanges in low-volume ETPs;
 - Reducing creation/redemption unit size in new or low-volume ETPs;
 - Providing lending options to assist with obligations under Regulation SHO;
 - Tightening price band parameters for new and low-volume ETPs.

Principles for Issuer-Funded Incentive Programs

In 2013, the SEC discussed aspects of the exchange pilots that helped mitigate potential concerns. These aspects included: robust disclosure provisions; application to a subset of less-liquid ETPs; and implementation on a pilot basis.²⁴ We agree that any issuer-funded incentive programs should have certain baseline features. In particular, given the considerations discussed above, if FINRA determines to permit issuer payment to market makers outside of exchange programs, we believe FINRA should address the following conditions in its proposal:

- *Transparency and disclosure* – Agreements between issuer and market maker should be objective, clear, and transparent to the public. Disclosure of agreements and terms should be uniform across issuers and be designed to enable investors to make informed decisions.
- *Promoting fairness* – Agreements should be fair and accessible to issuers and market makers alike. Issuers should have fair opportunity to access a broad pool of liquidity providers, and market makers should have fair opportunity to compete for payment.

²⁴ See *supra* notes 9 and 10.

- *Market quality* – Agreements should be reasonably designed to improve market quality and include oversight and monitoring by the issuer to ensure the expected benefits are achieved. Required disclosures could include reporting of market quality metrics alongside the agreement terms.
- *Regulatory oversight* – Agreements should be subject to surveillance, monitoring, and termination if expected benefits are not achieved. Regulators should periodically evaluate the impacts – intended and unintended – on market participants, securities, and markets in general. Agreements could be implemented as pilots where there is a data-gathering exercise at the end to ensure the expected benefits are realized.

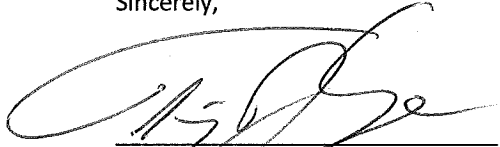
Conclusion

Market participants have advocated for permitting ETP issuers to pay market makers outside of exchange-administered programs. While changing the rule may seem straightforward at first glance, there are serious considerations that must be taken into account, to ensure the policy is good for investors. If FINRA permits ETP issuer payment to market makers, the policy should spell out key conditions including: transparency and disclosure, fair opportunity for issuers and market makers, market quality monitoring, and regulatory surveillance. Ultimately, the impact on investors and market quality as a whole should be central in FINRA's policy-making about issuer payment to market makers.

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We appreciate the opportunity to offer our perspective on this issue and would be pleased to discuss these comments in further detail. If you have any questions, please do not hesitate to contact me.

Sincerely,



Timothy J. Coyne
Global Head of Capital Markets
SPDR Business