



November 22, 2017

Jennifer Piorko Mitchell  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

**Re: FINRA’s Regulatory Notice 17-14 request for comments regarding FINRA Rules Impacting Capital Formation**

Dear Ms. Piorko Mitchell:

Cboe Global Markets, Inc. (“Cboe”) appreciates the opportunity to submit this comment letter in response to the request for comments by the Financial Industry Regulatory Authority (“FINRA”) on RN17-14 regarding FINRA rules impacting capital formation (the “Request for Comments”). Cboe operates four registered national securities exchanges in the U.S. for the trading of equity securities, one of which, Cboe BZX Exchange, Inc., (“Cboe Listings”) is a listing venue that currently lists 244 exchange-traded products (“ETPs”).<sup>1</sup> Cboe is a leading exchange operator for the trading of ETPs, with its four equity exchanges accounting for 21.58% of the daily trading volume in ETPs.<sup>2</sup> There are 194 members registered across Cboe’s four equity trading platforms with 105 quoting ETPs. Of these, only 24 are registered market makers in all (or some) US listed ETPs. As such, Cboe is acutely interested in the effectiveness and efficiency of all rules, operations, and administrative processes governing broker-dealer activities related to the capital-raising process and their impact on capital formation, especially as it relates to registered market makers and capital formation for ETPs. Cboe believes that FINRA Rule 5250 acts as a significant hindrance to an efficient capital formation process. For these and the reasons laid out below, Cboe believes that FINRA Rule 5250 should not apply to FINRA members for purposes of market making activity in ETPs.

**FINRA Rule 5250**

FINRA Rule 5250 prevents any member or person associated with a member from accepting any payment or other consideration, directly or indirectly, from an issuer of a security, or any affiliate or promoter thereof, for publishing a quotation, acting as market maker in a security, or submitting an application in connection therewith. Certain activities are exempt from Rule 5250, including: (1) payment for bona fide services, including, but not limited to, investment banking services (including underwriting compensation and fees); (2) reimbursement of any payment for registration imposed by the SEC or state regulatory authorities and for listing of an issue of securities imposed by a self-

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<sup>1</sup> Data current as of November 15, 2017.

<sup>2</sup> Based on data from October of 2017.



regulatory organization; and (3) any payment 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 SEC pursuant to the requirements of the Exchange Act.

As further explained below, Cboe believes that the adverse effects that Rule 5250 is intended to prevent, such as illusory trading activity that make it difficult for investors to ascertain the true market for the securities,<sup>3</sup> are mitigated by the derivative nature of ETPs and the associated arbitrage mechanism, that payment from an issuer for acting as market maker in an ETP could confer benefit to individual ETPs if the issuer decides to use this option, and, more broadly, that allowing payments by issuers to market makers could improve the ETP ecosystem in the United States to the benefit of market participants, including investors. For the foregoing reasons, Cboe believes that market making activity in ETPs should be included in the activities that are exempt from Rule 5250. In addition, Cboe believes that the decision to enter into these agreements is not intended to be a requirement but an option to be decided by the issuer on a product-by-product basis.

I. **Creation and Redemption – Derivative Pricing Mitigates Manipulation Risk**

The creation and redemption process for ETPs is the process by which market participants: (i) receive new shares of an ETP by providing a portfolio of the ETP’s underlying assets to the issuer of the ETP (“Creation”); or (ii) trade in existing shares of an ETP in exchange for receipt of a portfolio of the ETP’s underlying assets from the issuer of the ETP (“Redemption”). Creation and Redemption combined with secondary market trading provide both the means and the financial incentive for market participants to engage in trading activity that acts to keep the price of an ETP trading near the value of its respective underlying assets (the ETP’s “Indicative Value”) (the “Arbitrage Mechanism”). As a simple example, when the price of an ETP trading in the secondary market is less than the ETP’s Indicative Value, market participants stand to profit by engaging in Redemption: that is, buying the relatively underpriced shares of the ETP and exchanging them with the issuer of the ETP for the Indicative Value worth of underlying assets, which it can then sell in the secondary market at a profit. Inversely, when the price of an ETP trading in the secondary market is greater than the ETP’s Indicative Value, market participants stand to profit by engaging in Creation: that is, buying the Indicative Value worth of underlying assets and exchanging them with the issuer of the ETP for the relatively overpriced shares of the ETP, which it can then sell in the secondary market at a profit. These processes are at the core of ETP trading and re-enforce the fundamental concept that ETPs are derivatively priced securities.

Another feature of the Arbitrage Mechanism is mitigation of the risk to ETPs of market manipulation. Through a combination of the economic incentives described above and liquidity incentive programs offered by exchanges, market participants are able to provide significant liquidity and engage in

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<sup>3</sup> See Securities Exchange Act Release No. 69398 (April 18, 2013), 78 FR 24261 (April 24, 2013) (Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to FINRA Rule 5250 (Payments for Market Making)).

arbitrage activity that will keep the price of ETPs trading near their respective Indicative Value. As such, if the price of an ETP diverged from the easily calculated and widely disseminated Indicative Value of the ETP for any reason (including a firm acting as market maker trying to push the price of the ETP in either direction), market participants would have a means and economic incentive to bring that ETP's price back in line with the Indicative Value regardless of whether certain of the trading activity in the ETP is illusory.

Comparing the price discovery process for corporate securities to the derivative pricing of ETPs and the natural incentives to keep the price of an ETP in line with its Indicative Value, it immediately becomes clear that the policy concerns around market manipulation resulting from misaligned incentives on which Rule 5250 is based simply do not apply as it relates to market maker activity in ETPs.

## II. **The Marketplace Strongly Incentivizes Issuers to Prevent Manipulation**

In addition to the ability of the Arbitrage Mechanism to prevent manipulation of ETPs, the ETP marketplace actually strongly incentivizes issuers to prevent manipulation (even upward) in their ETPs. Ultimately, an ETP is a tool that investors use to gain portfolio exposure to a particular underlying asset. While management fees, the effective cost to trade (NBBO spread), and average daily volume are all important factors when evaluating similar ETPs offered by competing issuers, tracking error, or the measurement of how closely an ETP's trading activity tracks its underlying reference asset, is the ultimate measurement of whether the ETP is actually providing the portfolio exposure that the investor is seeking through the ETP. While it seems counterintuitive, if an ETP is not tracking the underlying reference asset that it is intended to track, then it is not providing investors with the exposure that they seek and therefore will be less preferable than other competing ETPs with lower tracking error that offer the same or similar exposure. For this reason, ETP issuers and exchanges expend significant effort and constantly monitor for trades away from the Indicative Value, whether higher or lower, and, where appropriate, bust or mark such a trade as aberrant so that it won't be included in tracking calculations. As such, ETP issuers are unlikely to encourage or incentivize manipulation of their ETPs because such behavior would result in tracking error, making an issuer's ETPs less desirable than those of their competitors. Based on the foregoing, the policy concerns around issuer incentivized quoting and trading on which Rule 5250 is based simply do not apply as it relates to market maker activity in ETPs.

## III. **Promoting Growth of the US ETP Industry**

Fund flows into ETPs are continuing to hit record levels at \$385 billion year to date compared to \$287.5 billion last year.<sup>4</sup> The number of listed products in the U.S. continues to accelerate with 240 launched so far in 2017 and initial seed investments for the 85 new launches on Cboe of approximately \$680 million, in large part from market makers. While exchange liquidity incentive programs help to encourage deep markets with tight spreads in ETPs, many ETPs, especially newer products, would

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<sup>4</sup> Based on inflows for US-listed ETPs YTD through October 31, 2017 as calculated and published by ETF.com.



benefit from a more precise, product-by-product incentivization structure. As the market continues to grow, issuers are looking both to expand their relationship with their market making partners and for ways to differentiate their ETPs from the competition. A tight and liquid market is paramount to both investor experience and an ETP's success and issuers and market makers are best positioned to understand what tight and liquid means for a particular product. Direct payments from ETP issuers to market makers is allowed in the majority of European markets and, while the agreements are not publicly available, feedback provided by ETP issuers, marker makers, and exchanges has been very positive.

Exempting ETPs from the restrictions of Rule 5250 will benefit the entire ETP ecosystem, including investor experience, by: (i) encouraging both new and existing market makers to commit capital and provide liquidity in ETPs, especially at product launch and in times of volatility when they are most needed; (ii) putting U.S. ETP issuers and market makers on equal footing with European competitors; and (iii) further promoting the ETP industry's resilience through this time of significant growth.

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Cboe appreciates the opportunity to reply to the Request for Comments. As discussed above, Cboe believes that exempting ETPs from the restrictions of Rule 5250 will provide a benefit to the U.S. ETP ecosystem without introducing the policy concerns that Rule 5250 was designed to mitigate. Cboe is acutely interested in the effectiveness and efficiency of all rules, operations, and administrative processes governing broker-dealer activities related to the capital-raising process and their impact on capital formation. Cboe welcomes the opportunity provide FINRA with any additional information that it might find useful or to further discuss any of the issues raised herein.

Sincerely,

A handwritten signature in black ink, appearing to read "Chris Concannon". The signature is fluid and cursive, with a long horizontal stroke at the end.

Chris Concannon  
President and COO