ETF BILD PROJECT

Business Insights | Leadership Discussion

January 26, 2018

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

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

Dear Ms. Mitchell:

ETF BILD[1] is pleased to have the opportunity to provide comments on FINRA Retrospective Rule Review on the Effectiveness and Efficiency of Its Payment for Market Making Rule ("Rule 5250"), Regulatory Notice 17-41[2] (the "Notice"). ETF BILD serves as a soundboard and place of interaction, debate, discussion and analysis for the business leaders of the ETF industry including ETF issuers and market makers, which allows us to offer objective and unbiased opinion on the Notice. We applaud FINRA for devoting the resources and attention to the issues raised in the Notice. As discussed herein, the maturing exchange-traded fund ("ETF")[3] industry is at a critical crossroads in terms of its ability to continue to offer a high quality exchange-based

[1] The ETF BILD (Business Insights & Leadership Discussion) is a forum located at www.etfbild.com with a mission to be the catalyst for discussions on the most pressing issues faced by the business leaders of the exchange traded fund (ETF) industry. The ETF BILD Project is at the intersection of academic research and actionable business leadership. The ETF BILD Project is focused on the business insights, leadership, and discussion of the ETF industry. The ETF BILD Project is 100% objective and unbiased and does not accept sponsored content or any form of pay-to-play exposure. The ETF BILD Project does not endorse any product or business nor recommend any investment action.

[2] See FINRA Regulatory Notice 17-41, November 28, 2017, Retrospective Rule Review.

[3] Our comment letter addresses exchange-traded funds, consistent with the ETF BILD Project's focus on exchange-traded funds registered with the SEC as investment companies because their assets primarily consist of securities. Many of our views expressed in this letter may apply to non-registered investment company exchange-traded funds, which are often called "exchange traded products" or "ETPs." The ETF BILD Project is focused on the business insights, leadership, and discussion of the ETF industry. The ETF BILD Project is 100% objective and unbiased and does not accept sponsored content or any form of pay-to-play exposure. The ETF BILD Project does not endorse any product or business nor recommend any investment action.

product that competes with other financial products as well as an integral component of an investor's portfolio. The ability for such the ETFs and/or their affiliates (collectively, "ETF Issuers") in such complexes to pay members for market making services will, as discussed below, benefit ETF Issuers and ultimately investors in terms of market making services such as offering a tight spread between the bid/ask price of securities while allowing members to be appropriately compensated for providing the services. ETF BILD is sensitive to the regulatory concerns that prompted the original adoption of Rule 5250; however, we believe that investors would be far better served by an amended Rule 5250 that protects them through disclosure and other forms of regulation in lieu of prohibition of these arrangements. The ETF share and the corporate security have different price discovery mechanisms and due to the ETF creation/redemption process have a very different structural process to bring shares to the market. In the opinion of The ETF BILD Project, we believe that this issue alone creates a different relationship between the ETF issuer and the market-maker that is not reflected in today's rule book. We want to thank FINRA for their periodic review of their rule book to keep it updated and to look at bringing new securities like ETFs into an updated rule book.

Recommendation

ETF BILD recommends that FINRA file a proposed amendment to Rule 5250 that exempts FINRA members for purposes of market making activity in ETPs and define suitable disclosure requirements for ETF Issuers who engage in market maker compensation arrangements.

Background

Rule 5250 prohibits member firms and their associated persons 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. FINRA has expressed the view that Rule 5250 is intended to, among other things, assure that a member firm act in an independent capacity when publishing a quotation or making a market in an issuer's securities. FINRA has stated that accepting such prohibited payments compromises the independence of a firm's decision regarding its quoting and market making activities and, among other things, harms investor confidence in the overall marketplace because investors are unable to ascertain which quotations are based on actual interest and which quotations are supported by issuers or promoters. Importantly, Rule 5250 was adopted to address these concerns with respect to corporate issuers but not specifically with respect to market making activities involving ETF securities.

Recommendation

ETF BILD recommends that FINRA file a proposed amendment to Rule 5250 to allow ETF Issuers to pay market makers for assisting the ETFs in a variety of ways, especially with enhancing market quality through improved quoting and trading of ETFs. Presently, many FINRA members lack the requisite incentive to provide vital services including maintaining tight bid/ask spreads for ETFs. It is important to emphasize that the liquidity for ETFs are reflected in the underlying shares of the corresponding index and accessed through the creation/redemption process. In comparison, corporate securities' liquidity is reflected at the quoted prices at the top of the book. ETF Issuers now steer marketing dollars that could have gone to market makers to general advertising, with the unfortunate result of paying for the marketing of a less attractive product offering (i.e., an ETF with high bid/ask spreads).

Market quality as reflected in the bid/ask price of an ETF is a key factor that financial advisers use when determining whether to invest client assets in ETFs and, if so, which ETFs. Allowing ETF Issuers to provide payment to market makers to help improve quality gives ETF issues the ability to have their product properly reflected in the marketplace. The current market structure for ETF pricing can at times not be reflective of the quality and availability of liquidity in an ETF and negatively effect execution quality.

ETF BILD recognizes that not all ETF Issuers because of a variety of business and other reasons need to compensate market makers; however, all ETF Issuers certainly would welcome the ability to choose to do so if such arrangements would benefit their product. The current prohibition imposed by Rule 5250 prevents ETF Issuers from having that choice.

Investor Protection

ETF BILD is convinced that FINRA can modify Rule 5250 to enhance market quality in the secondary trading of ETFs without sacrificing investor protections. The fundamental reason for this conviction is the significant difference between an ETF and an ordinary corporation, both in terms of their structure and the type of relationship and interaction they each have with their market makers. ETFs are passive investment pools that consist primarily of shares of thirty or more companies. The price of their shares are largely derived from the aggregate market price of each of the shares of the underlying companies they own divided by the number of ETF shares outstanding (i.e., the ETF's net asset value per share or NAV). Furthermore, a proxy of the NAV called the “Indicative Value” is disclosed and widely disseminated throughout the trading day and this disclosure combined with the unique arbitrage system in place for ETFs drives the ETF share price towards its NAV. Under this system, if a market maker made dubious prices, arbitrageurs through Authorized Participants could initiate in-kind transactions of the underlying securities to profit from the mispricing and such activity would bring the ETF share price back to its fair value or NAV.

This formulaic and mechanized process leaves virtually no opportunity for the ETF Issuer to pay a market maker to offer dubious quotations or prices or otherwise manipulate the price of an ETF shares. With respect to index ETFs, the rules governing those indexes are transparent. Consequently, market makers in ETFs are given no advantage by having a relationship, including a monetary relationship, with the ETF Issuer. That relationship exists today as many ETF Issuers have a “Capital Markets’ desk that regularly interacts with market makers for trade execution and for information about abnormal trading activity.

Shares of corporations, on the other hand, consist of assets that for the most part are subjectively valued. The SEC made this point when it approved Rule 5250: “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.”[4] This fact, combined with the absence of any self-correcting device like the ETF arbitrage process, in our view require the protections of Rule 5250 to remain in place for market making activities involving corporate securities but not ETF securities.

While ETF BILD believes the reasons for adopting Rule 5250 are not applicable with respect to protecting ETF investors, we believe that full and complete disclosure of market maker compensation arrangements would be a prudent way to eliminate or at least greatly minimize any potential for conflicts of interest that potentially arise from such payments. Disclosure is the hallmark of securities regulation as evidence by the prospectus and it should have a place in the regulation of payments from ETF Issuers to market makers. If a conflict and its potential consequences are disclosed, investors are better educated and able to make informed decisions. Disclosure is also a strong deterrent for conflicts of interest because the omission of the required disclosure could lead to serious consequences for the ETF Issuers and makers participating in the compensation arrangements. FINRA and the SEC through their respective inspection

[4] See Securities and Exchange Commission Release No. 34-38812; File No. SR-NASD-97-29.

and examination powers would also have the ability to monitor the compensation arrangements for conflict of interests and any practices harmful to investors. This regulatory scheme could be further enhanced by requiring participants to create and maintain records of such arrangements, as well possibly reporting certain information about such arrangements to FINRA or the SEC.

Conclusion:

ETF BILD strongly recommends that FINRA file a proposed amendment to Rule 5250 that would exempt FINRA members for purposes of market making activity in ETFs. The proposed amendments would be coupled with disclosure, recordkeeping and reporting requirements designed to make these arrangements transparent to regulators and investors, thereby reducing the potential for conflicts of interest.

We appreciate having the opportunity to comment on the proposal, and we stand ready to assist FINRA in any way that we can. If you have any questions, please contact the undersigned at (914) 406-6277.

Sincerely,

/s/ Richard Keary
Richard Keary
Founder

/s/ Justin Meise
Justin Meise
Founder

/s/ John Jacobs
John Jacobs
Founder

/s/ Bibb L. Strench
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