January 29, 2018

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

Re: Regulatory Notice 17-41

Dear Ms. Mitchell,

IMC Chicago, LLC d/b/a IMC Financial Markets ("IMC") appreciates the opportunity to submit this letter in response to Financial Industry Regulatory Authority ("FINRA") Regulatory Notice 17-41 requesting comment on the current impact and effectiveness of FINRA Rule 5250 (Payments to Market Makers), a prohibition in effect in one form or another since 1975. IMC believes the time is right to modernize Rule 5250 and permit issuers of exchange traded products ("ETPs") to offer customized, transparent payments to market makers, either directly or facilitated through exchange pass-through mechanisms, particularly regarding newly launched or thinly traded products.

Background

IMC

Founded in 1989, IMC recognizes the role of technology in making markets more efficient. Investing in both technology and people, IMC is one of the largest market makers in exchange traded instruments, operating as a market maker across numerous US exchanges, as well as a Lead Market Maker ("LMM") on NASDAQ, NYSE Arca, and BATS and a Designated Market Maker in over 575 symbols on the floor of the New York Stock Exchange.

IMC's LMM operations includes over 150 ETPs, with obligations to maintain markets in its assigned symbols on NASDAQ, NYSE Arca, and BATS. As such, IMC is well positioned to understand the current balance of risks, costs and rewards associated with making markets in ETPs. We are also heavily invested in participating on efficient, stable and transparent markets. Indeed, IMC believes that any market structure review or proposed rule change should be geared towards enhancing liquidity provision and the price discovery function of exchanges. Unfortunately, as described more fully below, the current mix of risks, costs, and benefits are not fully aligned to adequately incentivize market makers in ETPs—particularly in newly launched or thinly traded products.

Growth of ETPs

The interest in ETPs has grown over the past several years, with assets under management as of the end of 2017 valued at over $3.4 trillion. As of December 31, 2017, there were over 2,100 ETFs listed in the U.S., with approximately 1.2 billion ETF shares traded daily, representing $69 billion in average daily traded value. The value drivers, however, are increasingly concentrated in a handful of ETPs. According to some reports, for example, over half of new investments in the first half of 2017 have gone to only 20 funds.[1] In this context of growth and concentration, it is reasonable to review the prohibition of Rule 5250, so as to assess and re-align incentives in order to foster meaning competition and liquidity.

Rule 5250

The prohibition on accepting payments for market making activities was first articulated as guidance in 1975 and was ultimately codified in 1997. The prohibition of such payments was designed to eliminate any appearance of conflicts of interest, since such payments may be viewed as influencing decisions as to whether to quote or make a market in a security and at what prices.[2] Upon the guidance becoming a rule, FINRA reiterated its concern that payments by an issuer to a market maker may influence a firm's decision to make a market.[3] By prohibiting private, undisclosed arrangements, FINRA sought to eliminate the appearance that otherwise independent trading activity was illusory.

In 2013, however, in reaction to exchanges recognizing an increasing imbalance in the mix of costs, risks, and benefits associated with making markets in ETPs—and the resultant desire to facilitate increased incentives via issuer based payments—FINRA revised the outright prohibition to permit issuer payments to be made via exchange administered programs. FINRA believed that the transparency offered by exchange administered programs alleviated historical concerns regarding such payments.[4]

Two such exchange administered programs were subsequently approved, namely NASDAQ's MQP Program and NYSE Arca's ETP Incentive Program. NASDAQ and NYSE Arca each recognized the particular need to incentivize market making in newly launched and thinly traded ETPs, and thus sought to facilitate issuer payments to more adequately offset the costs of making markets. IMC supported each of these efforts, comforted in large part by the transparency they required, but we warned that as costs rose and incentives eroded, increasingly less liquidity providers would be willing to act as lead market makers. Indeed, we are currently witnessing an increasing lack of diversity and competition amongst market makers, as the barriers to entry are

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[1] *See* Market Watch, *Less than 1% of ETFs getting half of all inflows in 2017*, July 20, 2017, available at https://www.marketwatch.com/story/less-than-1-of-etfs-getting-half-of-all-inflows-in-2017-2017-07-19.

[2] *See* Notice to Members 75-16 (February 1975).

[3] *See* NASD Notice to Members 96-83 (December 1996).

[4] *See* Order Approving a Proposed Rule Change by Financial Industry Regulatory Authority, Inc. Relating to FINRA Rule 5250, Securities Exchange Act Release No. 34-69398 (April 18, 2013), 78 FR 24261 (April 24, 2013) (SR-FINRA-2013-020). FINRA was further comforted by the fact that regardless of these newly excepted payments, the related trading activity remained subject to and governed by the established market surveillance and oversight procedures of the national securities exchanges.

high and the rewards insufficient to cover the associated costs and risks. Over the last two years alone we have observed several premier, top tier investment banks and historical market makers shift away from this model and exit the LMM business as a result of the increasingly inefficient structure.[5] In this context, FINRA is correct to re-visit whether the prohibition of Rule 5250 should be reviewed and modernized—at least with respect to newly launched or thinly traded ETPs.

Current Misalignment of Incentives

As dedicated providers of liquidity, LMMs are exposed to certain costs and risks associated with their market making assignments. Among these risks and associated costs are low inventory turnover rate stemming from low volume and access to reliable and cost efficient hedges for increasingly complex products. As a direct result, the costs associated with holding a position in thinly traded or complex ETPs necessarily increases over extended periods of time.

Unfortunately, the current exchange administered approach—including volume based incremental fee differentials—do not adequately incentivize competition nor offset the rising costs associated with making markets in these products. To address the deficit between costs and benefits of LMM participation, issuers and LMMs have turned to developing portfolios of assignments in the hopes of identifying the right mix of products that in the aggregate offer the prospect of profitability. This approach is effective only as long as there are highly liquid products to subsidize the issuance of new or thinly traded products. Paradoxically, bundling portfolios may actually further impair the liquidity issue, as LMMs are incentivized to make markets in the high volume symbols but not the thinly traded ones in order to benefit from volume based incentives. This misalignment is driven in part by an antiquated Rule 5250.

Proposal to Modernize Rule 5250

IMC believes that the time is right to modernize Rule 5250 and permit issuers of ETPs to offer customized payments to market makers, either directly or facilitated through exchange pass-through mechanisms, particularly regarding newly launched or thinly traded products. Eligible ETPs and the range of payment amounts, of course, be subject to reasonable and easily accessible disclosure requirements. With transparency, investors will be alerted to these arrangements, thus eliminating the historical concern regarding undisclosed, private dealings which might render as illusory what is actually independent trading activity. Customized payments when coupled with reasonable transparency requirements satisfied by the issuers (either themselves or via an exchange mechanism) places responsibility on the party best suited to know which of its products is in need of additional incentives. This proposal is designed to make it easier for issuers to tailor incentives and for investors and participants to readily identify products and payments. We believe this more flexible approach, adhering closely to the principle of reasonable disclosure and transparency, will help re-balance incentives and thereby foster greater competition amongst issuers to introduce new compelling ETPs and lower the barriers to entry for new market makers.

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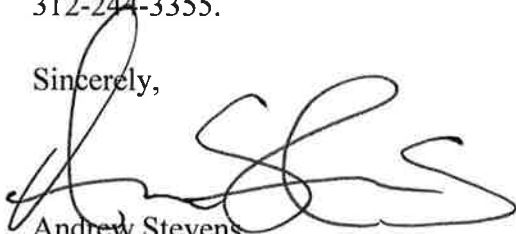
[5] *See* Bloomberg, *Old Wall Street is Losing the War Under the Surface of ETFs*, October 16, 2017, available at https://www.bloomberg.com/news/articles/2017-10-16/old-wall-street-is-losing-the-battle-beneath-the-surface-of-etfs.

Conclusion

For the foregoing reasons, IMC respectfully urges FINRA to review and modernize Rule 5250. As described herein, customized, transparent payments to market makers, either directly or facilitated through exchange pass-through mechanisms, will help re-balance incentives and thereby foster greater competition amongst issuers to introduce new compelling ETPs and lower the barriers to entry for new market makers —to the benefit of all market participants.

Should you have any questions in connection with our comments, please feel free to contact me at 312-244-3355.

Sincerely,



Andrew Stevens
General Counsel