SIG

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Submitted via email: pubcomm@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, DC 20006-1506

RE: Regulatory Notice 17-41:
Retrospective Review of the Rule Governing Payments for Market Making

Dear Ms. Piorko Mitchell:

Susquehanna International Group, LLC ("SIG") is pleased to submit this letter in response to the Financial Industry Regulatory Authority's ("FINRA") Regulatory Notice 17-41 requesting comment on the efficiency and effectiveness of FINRA Rule 5250.[1] We appreciate FINRA's willingness to examine whether this rule is meeting its intended objectives and to consider whether alternative frameworks might allow for continued achievement of the rule's goals while helping to increase the market quality of Exchange Traded Products ("ETPs"). Currently, Rule 5250 prohibits issuers from paying broker-dealers acting as a market maker. In 2013 this rule was amended to allow payment to market makers indirectly through exchange programs.[2] Some of the commenters to Regulatory Notice 17-41 support an amendment to enlarge the exemption to permit the direct payment from ETP issuers. We do not believe that a revision to Rule 5250 making an exemption for ETPs would be advisable *at this time*.

While we support the industry's ongoing efforts to improve ETP market quality and acknowledge that allowing direct payments from issuers to market makers could possibly improve liquidity, we believe that direct payment systems will fall well short of serving as a panacea for ETP liquidity in the United States, as other responders to this rule review have suggested, and would expose the marketplace to unnecessary uncertainty and potential disruption.[3] We note that currently there are a number of tools available for improving ETP market quality and urge the industry at large, and the issuer community in particular, to focus on taking full advantage of these mechanisms prior to inviting the potential for unforeseen problems resulting from changes to the rules governing the marketplace and its various participants.

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[1] SIG is a global quantitative trading firm and one of the biggest liquidity providers in ETPs since their inception in the 1990s. SIG has more than 500 clients and trading partners in the U.S. and is a registered market maker in virtually all 2,000+ U.S. Listed ETPs across all asset classes, serving as Lead Market Maker in over 325 listings.

[2] Order Approving a Proposed Rule Change by Financial Industry Regulatory Authority, Inc. Relating to FINRA Rule 5250 (Payments for Market Making), Exchange Act Release No. 69398, 78 Fed. Reg. 24,261 (Apr. 18, 2013).

[3] To be clear, we do not intend in this letter to make any comment on the viability or necessity of direct payments for market making in Europe or other markets outside of the United States. The marketplaces differ in fundamental ways, with significant distinctions in market structure, regulatory frameworks, and infrastructure requirements. Accordingly, for purposes of the current discussion we believe that reference to Europe or elsewhere do not provide appropriate support for the changes being contemplated in the U.S.

Changes to incentives carry the risk of unintended consequences

As the equity marketplace is a complex network of interrelationships, changes to the incentives that govern the behavior of its participants carry the risk of unintended consequences leading to undesired outcomes. We believe it is premature to permit direct compensation structures without considerable additional input from all types of ETP industry members, and instead encourage that we focus our collective energies on improving liquidity in the ETP marketplace using the variety of existing enhancements to ETP mechanics that we already have at our disposal. Such tools have been employed to varying degrees by some within the industry, but have not yet been widely utilized to their fullest extent. These measures have a broad market advantage over any proposed system of direct payment in that they enable any and all market participants to provide liquidity at tighter levels, whereas payments would serve to motivate only those who receive compensation. The existing tools described below can create natural and meaningful improvements in ETP market quality by way of general product-related changes, without the need for direct compensation of only specific participants, with its associated risks and limitations.

Tools for improving market quality exist currently and deserve further attention

While we argue against a revision of Rule 5250 for ETPs at this time, we view the current discussion as a useful opportunity to highlight the wide range of tools for enhancing ETP market quality that already exist at issuers' disposal and encourage their continued use.

Share Splits and Creation Unit Size Decreases

Measures like share splits and reducing the share quantity per creation unit, for example, can dramatically reduce the cost of carry incurred by a market maker quoting a thinly-traded ETP. In the absence of robust, two-way trading in the secondary market for a particular product, liquidity providers manage their positions by transacting in the primary market for that ETP through the creation and redemption process. When a market maker exhausts its inventory in a thinly-traded ETP, it often has little choice but to place a creation of new shares upon its next sale of shares in order to make delivery, even if for a very small short position.[4] In the face of tepid investor demand and low trading volumes, selling out of the residual inventory resulting from the creation can take months and sometimes years, during which time market makers can incur significant carry cost from holding and hedging this position. Faced with this prospect, market makers will often price the expected carry cost into their quotes, resulting in a wider bid-ask spread, which is often cited as a source of frustration from both issuers and investors. Additionally, a market maker may simply stop quoting the product after exhausting its inventory, in order to avoid taking on new inventory, thus decreasing the number of market participants providing liquidity in the name. Neither of these outcomes is positive for ETP liquidity. Share splits and creation unit size reductions help mitigate this issue by decreasing the notional size of the positions that market makers must manage in these scenarios, thereby decreasing the cost of carry incurred by the market maker and ultimately passed on to investors.

Sales and Marketing

Concerted, coordinated sales and marketing efforts by issuers can serve a similar beneficial purpose for ETP market quality. Driving investor interest in an ETP helps increase trading activity, resulting in a more robust secondary market in which market makers can manage their positions at the ETP share level rather than exclusively through primary creation and redemption transactions. In doing so, it can shorten the time it takes to sell out of inventory, thereby reducing carry costs, which as described above can translate to tighter bid-ask spreads.

[4] By definition, creations (and redemptions) can only be transacted in "Creation Unit" size increments, typically 50,000 or 100,000 shares.

We recognize that it is a challenge for ETP issuers to achieve meaningful sales progress for thinly traded ETPs, particularly those with bid-ask spreads significantly wider than actively-traded competing products. In the interest of improving the liquidity conditions for such products, we encourage the issuer community to identify certain "focus products" among them, based on prevailing or projected market conditions and investor appetites, and further to develop comprehensive sales and marketing strategies to promote these products in the marketplace. Often, a key facet of a concerted distribution effort is coordination between the issuer's own Capital Markets team and its market making partners. We and other Lead Market Makers are generally more inclined to offer tighter on-screen liquidity for "focus products" that our issuer partners themselves have made a commitment to support in the form of targeted marketing campaigns (for the aforementioned reason of reduced expected carry cost). Additionally, potential opportunities for client engagement can further incentivize those market makers with client-facing capabilities. This type of interaction serves a mutual benefit to all parties, the market makers, investor clients, and issuers alike.

While it is no trivial task to generate product interest in an increasingly crowded market, we believe that steps taken by issuers to increase the coordination between sales, marketing, and capital markets in this fashion can lead to positive outcomes for an ETP's liquidity profile and ETP market quality generally.

Creation and Redemption Fee Waivers

The bids and offers quoted by market makers in a thinly-traded ETP are driven by the total cost incurred to create round Creation Unit increments of said ETP's shares.[5] Market makers manage their positions in these types of products mainly through creation activity, which entails transacting in the primary markets as described above. The overall cost to create a unit of an ETP is based on a number of component costs, including: 1) the bid-ask spread of the product's underlying basket of securities, 2) underlying transaction costs such as exchange and market access fees, along with the associated price impact incurred by sourcing these securities, as well as foreign stamp taxes and foreign exchange costs for international securities, and 3) creation fees charged by the ETP itself (or its custodian) in order to cover trading and clearing costs within the fund.

Since these such creation costs are the principal drivers of bid-ask width for thinly-traded ETPs, any reduction in these costs can lead to tighter spreads. Creation fees, particularly high ones, can represent outsize contributors to overall bid-ask width. Waiving or subsidizing these fees can serve as a powerful and simple means for reducing the cost of creating an ETP. Although the trading and clearing costs these fees are designed to cover will not disappear, a waiver effectively transfers the burden of these costs from market makers – who pass them along to investors in the form of wider spreads – to the ETP issuer or its custodian, who can absorb the cost themselves. This measure can be thought of as a "liquidity subsidy" paid by the issuer in the name of improving market quality and facilitating tighter pricing for the investor.

Creation fee waivers carry an explicit cost for ETP issuers, much as any system of direct payment. However, measures such as fee waivers carry two distinct advantages when compared to direct payment. First, a fee waiver enables *all* market participants to provide liquidity at tighter levels, promoting more participation and competition from multiple parties. Direct payment, on the other hand, provides an artificial incentive *only* to those being paid. Second, a benefit for ETP issuers: on days with no creations, the fee waiver would cost the ETP issuer who offers it nothing. The liquidity benefit would still be present, however, as market makers will likely price tighter markets on ETPs any time they know the fee waiver is in effect, regardless of whether they are creating on that particular day or not. Meanwhile, under a system of payments to market makers, presumably fees would be incurred by the issuer for any and all days that the market maker provides their quotes.

[5] For purposes of this discussion, all references to "create/ creation/ creating" also include "redeem/ redemption/ redeeming."

For these reasons, fee waivers and reductions serve as more efficient uses of ETP issuer capital than direct payments. Compared to direct payment, they could create a more level playing field between ETP issuers of varying sizes and capital bases for improving liquidity.

Liquidations and Delisting

We also appreciate the recent increase in liquidations and de-listings. Over the past few years we have seen new products issued at a brisk rate, which has increased the number of thinly traded ETPs in the market. We commend the decision by issuers to close down older securities that have failed over time to garner significant investor interest. By doing so, these issuers reduce the perceived risk among market makers that their quoting activity in less active listings may result in inventory they are forced to carry in perpetuity. With this reduction in risk, we believe, comes a greater willingness to provide liquidity generally in less-active products, exactly the objective of the current discussion of the Rule.

While growing the number and variety of ETPs is desirable, the capital, technology and time supporting this product set are finite resources and must be allocated in an efficient manner. Accordingly, we support the industry's critical evaluation of not only new launches but also existing products.

Conclusion

Each of the above-mentioned tools can help improve ETP liquidity without requiring significant changes to the existing regulatory framework, including Rule 5250. While we do not oppose a larger and more detailed conversation about the desirability of direct payment for market making by ETP issuers, we urge industry members not to let this conversation distract from the mechanisms that are currently in place to improve market quality.

The past few years have seen a number of issuers exhibit increased willingness to implement share splits, creation unit size decreases, concerted sales and marketing efforts, creation fee waivers or reductions, and product liquidations in order to help decrease liquidity provider creation costs and carry costs. We applaud these efforts and point to the beneficial effect they have had on the liquidity of those ETPs. We encourage the continued adoption of such measures, and remain available to engage in further, product-specific discussions with our ETP issuer partners upon request.

SIG supports efforts to maximize investor outcomes in our existing regulatory framework using the totality of approaches already at our disposal before resorting to new incentive structures. Taking this time to study these existing approaches will help evaluate whether revisions to the rules are warranted and, if so, will enable the market to develop a keener sense of how direct payment might be beneficial and most appropriately implemented.

Sincerely,

Damon Walvoord
Co-Head ETF Group

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