FG Consulting & Advising, LLC

Digital & Strategy
Research, Trading and Investing

January 29, 2018

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

Re: FINRA Regulatory Notice 17-41 – Request for Comments on the Effectiveness and Efficiency of Its Payments for Market Making Rule

Dear Ms. Mitchell:

FG Consulting & Advising, LLC ("FG" or "I") is grateful for the opportunity to comment in response to FINRA Regulatory Notice 17-41 on the Effectiveness and Efficiency of Its Payments for Market Making Rule. Based on 15 years of experience and interactions primarily with retail, self-directed investors and traders, these comments offer a somewhat different perspective from those comments already submitted by Cboe Global Markets, Inc.[1], Virtu Financial[2], and The Securities Traders Association[3]. In summary, I agree with the conclusion of the three letters in that FINRA Rule 5250 should be relaxed to permit ETP Market Makers to accept payments from ETP sponsors. However, (1) definite rules of conduct should be established defining how and under what scenarios ETP Market Makers can participate in the market based on these incentives and (2) it must be transparent to the market which ETPs are in fact paying for market making support.

Background

Exchange Traded Products ("ETP") [Exchange Traded Funds ("ETF"), Exchange Traded Notes ("ETN"), and Non-1940 Act Pooled Investment Vehicles][4] are becoming increasingly important to Americans' financial well-being, replacing both individual securities and open-end mutual funds in investors' portfolios, and offering diversification into new asset classes (e.g. precious metals and commodities). For individual investors in taxable accounts, the ETF structure generally represents a more tax-friendly alternative to that of traditional open-end mutual funds, helping spur their growth.

---

[1] http://www.finra.org/sites/default/files/notice_comment_file_ref/17-41_Concannon_Comment.pdf
[2] http://www.finra.org/sites/default/files/notice_comment_file_ref/17-41_virtu_comment.pdf
[3] http://www.finra.org/sites/default/files/notice_comment_file_ref/17-41_STA_comment.pdf
[4] https://www.sec.gov/rules/other/2015/34-75165.pdf, pages 6-8

In 2017, flows into ETPs totaled a record $476.1B[5]. There is however, a significant concentration in those flows with the 10 largest ETP creations (net new flows) in 2017 totaling over $150B or 32% of the total flows[6]. And while there were 275 new ETP launches in 2017, there were also 138 ETP closures, meaning a 50% birth/death ratio[7]. Attracting assets to new ETPs, especially by smaller or newer providers is a difficult challenge that increased market maker support could help overcome.

ETPs also represent a large and growing share of trades in the U.S. market. Of the top 15 traded securities in the U.S. in 2016, only one was a stock. The remaining 14 were ETPs. The growth in ETP trading has also exceeded the growth of trading in stocks with ETP trades now representing 23% of daily share volume.[8]

As retail investors' use of ETPs has grown, ETP resources have become central to the competition among online brokers. Major online brokers have been aggressively courting retail customers with ever-broadening lists of ETPs that trade commission free. Fidelity, E*Trade, Charles Schwab, and TD Ameritrade now offer 90+, 140+, 200+, and 250+ different ETPs respectively that can be traded without commissions.[9] TD Ameritrade just launched 24-hour ETP trading to its customers this month, enabling them to trade broad-based market ETPs around the clock.[10]

Retail ETP traders and investors vary greatly in their understanding and sophistication. ETPs appeal to two, somewhat distinct groups of individuals. Some are traders who understand how the equity markets function. They historically traded individual stocks and now use ETPs for tactical tilts, leverage, hedging, access to alternative asset classes, or as an inexpensive core portfolio. The other group of investors are either new to investing or have previously invested only in open-end mutual funds. They do not necessarily understand how the market functions or how premiums/discounts to NAV and bid/ask spreads for ETPs impact their investments' performance.

Recommendations

(1) Incentive payments to Market Makers from ETP sponsors should be permitted under a new exception to Rule 5250. It will be important to define the activities permitted under this

---

[5] http://www.etf.com/sections/weekly-etf-flows/2017-etf-inflows-big-record-breaker
[6] ETF.com/Factset data
[7] ETF.com/Factset data
[8] Credit Suisse Market Structure Review 2016/2017.
[9] Company websites as of 1/29/2018
[10] https://www.amtd.com/newsroom/press-releases/press-release-details/2018/TD-Ameritrade-Introduces-24-Hour-Access-to-the-US-Equity-Markets/default.aspx

exception. These activities should be limited to enhancing liquidity and narrowing the market spread and not to supporting ETP prices (and thereby hindering price discovery).

ETP prices have become a valuable source of information to the markets. Often, these prices can be more indicative of the true market value of the assets in the ETP than data from other sources. Price supports could interfere with that market mechanism, leading to potential mispricing of a specific ETP as well as other similar assets. The creation/redemption mechanism cannot always be counted on to ensure intraday efficiency, especially for harder to value or trade assets and for retail investors who do not have direct access to this mechanism.

Many retail investors use the intraday net asset value ("iNAV") as a reference point for their trading. The iNAV is a derived calculation based on the pricing of the underlying constituents of a reference basket. The calculation has limitations as to its timeliness and accuracy[11], so it is critically important that any supported market making activities do not create new opportunities for arbitrage that would negatively impact retail investors. Retail investors using iNAV are already at a disadvantage to many institutions that have the capability to price the full holdings of the ETP on a continuous, real-time basis.

(2) Transparency – It must be clear to the market which ETP sponsors are in fact paying for market making support. If an end date for market making support is known/defined for a specific ETP, that information should also be publicly available. This will ensure that an investor doesn't unknowingly purchase an ETP where market maker support will be ending, reducing the trading efficiency of the ETP.

A mechanism should be implemented to distribute an indication of market making support to all market participants in a manner similar to the one that Nasdaq requires for their Financial Status Indicator ("FSI").[12] This will be especially important to retail investors who might not otherwise be aware of the fact that the trading of an ETP is supported by payments from the sponsor.

---

[11] E.g. Fixed income ETF iNAVs may be based on less timely trades due to infrequent transactions of specific bonds. iNAVs for ETFs holding foreign securities that trade on a different schedule than U.S. markets may be stale due to news since the foreign market's closure. See http://www.etf.com/etf-education-center/21028-understanding-inav.html, https://www.ishares.com/us/education/market-value-etf-prices, and https://www.libertyshares.com/capital-markets-corner-give-inav-break/

[12] http://www.nasdaqtrader.com/TraderNews.aspx?id=nva2005-057

FG Consulting & Advising, LLC

Digital & Strategy
Research, Trading and Investing

Reasons for the Change

The emergence of ETPs has been a net positive for the market. They have been drivers of the reduction in investment management fees paid by investors. They have facilitated new approaches to managing investments (robo-advisors), and enabled investors to get access to new types of assets relatively inexpensively and simply. By permitting ETP sponsors to pay for market making support, FINRA can help new ETP entrants more easily get to market and achieve a sustainable level of assets.

This market making support can help investors as well. Market making support should lower trading costs by enhancing market liquidity, reducing the cost to an investor of buying or selling an ETP. Improving the trading efficiency of new ETPs will spur competition, better enabling new, and potentially less expensive products, to compete against more established products. Better trading characteristics as a result of market maker support should also speed up access to new products by accelerating brokerage firms' and RIAs' processes for approved/recommended product lists.

* * * * *

FG Consulting & Advising, LLC appreciates the opportunity to provide comments on potential changes to FINRA Rule 5250. Well structured changes to the rule for ETPs can facilitate market growth and help individual investors. I would be happy to answer any questions or provide additional detail as requested by FINRA.

Sincerely,

Frank Gold

Franklin Gold
President
FG Consulting & Advising