January 22, 2018

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:

The Security Traders Association, ("STA")[1] welcomes the opportunity to offer comment on FINRA Retrospective Rule Review on the Effectiveness and Efficiency of Its Payment for Market Making Rule ("FINRA Rule 5250" or "Rule 5250"), Regulatory Notice 17-41[2] (the "Notice"). STA's diverse membership, as measured by geography and business models, offers a unique perspective on the Notice which we hope will contribute favorably to any strategic decisions with respect to FINRA Rule 5250. STA commends FINRA for identifying Rule 5250 as part of its Retrospective Rule Review initiative.

Summary Views

STA recommends that FINRA file a proposed amendment to Rule 5250 that would: (a) permit FINRA members to accept one or more payments from the issuer of an Exchange-Traded Product ("ETP")[3] for purposes of acting as a registered market maker in the ETP; and (b) define suitable disclosure requirements for such market maker compensation arrangements. In our letter, we provide principle based explanations for such a rule filing and have identified specific areas where we recommend FINRA solicit industry input.

[1] STA is a trade organization founded in 1934 for individual professionals in the securities industry. STA is comprised of 24 Affiliate organizations with 4,200 individual professionals, most of who are engaged in the buying, selling and trading of securities. The STA is committed to promoting goodwill and fostering high standards of integrity in accord with the Association's founding principle, Dictum Meum Pactum – "My Word is My Bond"

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

[3] While there are differences in how Exchange Traded Funds, (ETFs) and ETPs are structured, they have similarities in the way they trade and settle. Thus, for purposes of simplicity, references to ETPs include ETFs and ETPs which have been approved by the Commission and comply with the Investment Company Act of 1940.

FINRA Rule 5250 explicitly prohibits a member or associated person from accepting payment or other consideration, directly or indirectly, from an issuer or its affiliates or promoters, for publishing a quotation, acting as a market maker in a security, or submitting an application in connection therewith. Rule 5250 is intended to protect investors from harm caused by artificial quotes and prices which may originate from conflict of interests associated with such payments. STA believes that Rule 5250 can be modified to enhance market quality in the secondary trading of ETPs without degrading its intended investor protections. STA therefore recommends that FINRA file a proposed amendment to Rule 5250 that would exempt FINRA members for purposes of market making activity in ETPs and define suitable disclosure requirements for ETP issuers who engage in direct market maker compensation arrangements.

As we will explain in more detail, the derivative nature of ETPs provides an efficient arbitrage mechanism which ensures ETP prices align with the market values of the underlying securities. STA believes this arbitrage mechanism provides investor protections intended under Rule 5250. In other words, the price of an ETP is derived from its underlying basket of securities. Thus, any perceived conflict relating to market maker payments is vitiated by the fact that the price of the ETP is effectively controlled by the quotes/trades of securities for which the market maker has not received any payment. To be clear, STA believes Rule 5250 should continue to apply to market making activity in single stock issues (i.e., non-ETPs).

Background

Rule 5250 was originally introduced in a *Notice to Members* in 1975 and codified in 1997 when the Securities and Exchange Commission ("Commission") approved SR-NASD-97-29[4]. In its approval, the Commission identified factors firms consider when making a market in a security and the prices they quote.

Specifically the Commission wrote:

> *"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."*
>
> *"Public investors expect broker-dealers' quotations to be based on the factors described above. If payments to broker-dealers by promoters and issuers were permitted, investors would not be able to ascertain which quotations in the marketplace are based on actual interest and which quotations are supported by*

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

issuers or promoters. This structure would harm investor confidence in the overall integrity of the marketplace."

Recent FINRA Actions; Exchange Programs

In 2013, FINRA Staff received inquiries regarding Rule 5250's application to arrangements with national securities exchanges.[5] FINRA analyzed certain exchange program structures, such as the programs adopted by NASDAQ[6] and NYSE Arca[7]. The structures of these exchange programs were different, but they shared an intended goal of enhancing market quality for certain exchange-trade products through exchange run payment programs that were partially funded by ETP issuers. While FINRA found that such programs could be deemed an indirect payment under Rule 5250, FINRA reasoned that such arrangements should not be prohibited under Rule 5250 since those payments are part of a transparent structure in place by another Self-Regulatory Organization, ("SRO") pursuant to a rule change, which generally must be approved by the SEC following notice for public comment. The Commission approved such payment arrangement programs and Rule 5250 was consequently amended to add section (b)(3).[8]

STA General Statements

Arbitrage Mechanism and ETP Quotes & Prices

The derivative nature of ETPs and today's highly technologically advanced and interconnected market structure enable ETP prices to align with the market values of the underlying securities. Situations where prices do not align are eradicated by other market participants. STA agrees with certain remarks in the Cboe Global Markets letter[9] to FINRA dated November 22, 2017, describing how the ETP "Arbitrage Mechanism" mitigates the risk of market manipulation because,

"… 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

[5] SEC Release No. 34-69398 (April 18, 2013).

[6] SEC Release No. 34-69195 (March 20, 2013). Market Quality Program, (the "MQP"), whereby a sponsor or entity (a "MQP Company") that lists MQP securities may pay a fee that will be used to incentivize market-makers to enhance market quality for MQP securities. In addition to the standard NASDAQ listing fee, the MQP Company pays a fee to NASDAQ that is split between quoting and trading incentive payments to participating market-makers.

[7] SEC Release No. 34-69335 (April 5, 2013). NYSE Arca's filing of a proposal that would create a one-year pilot program for issuers of certain exchange-traded products listed on NYSE Arca. The pilot program was designed to enhance market quality for certain exchange-trade products by incentivizing market-makers to take lead market-maker assignments in lower volume exchange-traded products by offering an alternative fee structure wherein the lead market-makers would be funded from NYSE Arca's general revenues.

[8] 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. 69,398, 78 Fed. Reg. 24261 (Apr. 18, 2013).

[9] Cboe Global Markets letter to Jennifer Piorko Mitchell Office of the Corporate Secretary FINRA, (November 22, 2017)

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."

While variances in the efficiency of the arbitrage mechanism may exist, STA believes such occurrences are nuanced and attributed to liquidity in the individual ETP and not the differences in how ETPs are structured.

Unique Initial and Ongoing Costs

STA believes that the factors in a firm's decision to make a market in a security are separate from the factors that determine the prices or quotes at which they trade or publish. Generally speaking, the primary factor in a firm's decision to make a market in a security is the ability for that firm to recoup the initial costs of doing so. Under Rule 5250, firms are only able to recoup initial costs associated with market making after the decision to do so has been made. Even at that point, recouping initial costs is less certain.

Factors for determining price or quotations are as the Commission identified; *supply and demand, the firm's expectations toward the market, its current inventory position, and exposure to risk and competition.*

In situations involving ETPs, firms incur costs with trading these securities not incurred with the trading of single stock issues. The required seeding of the underlying components of the ETP and the complexity of monitoring the prices of an ETP's underlying components on a continual basis are unique and incremental costs which are not incurred with market making activity in single stock issues.

Unreasonable Barrier to Entry

STA generally believes that barriers to entry degrade overall efficiency in markets because they impede competition and the benefits that it provides to investors in areas such as choice and lower costs. However, we also believe that barriers to entry can provide investors with protections that outweigh overall market efficiency. Therefore determinations as to whether a barrier to entry is reasonable or unreasonable need to consider the investor protections it provides and the impact it has on overall market efficiency.

With respect to ETPs, STA believes that there are barriers to entry to market making firms caused by initial and ongoing costs. STA also believes that amending Rule 5250 so as to allow, but not require, issuers of ETPs to engage in market maker compensation arrangements would provide a means to address or neutralize these costs, thereby lowering a barrier to entry.

The intended protection Rule 5250 provides investors is the certainty that quotes or prices are not artificial or the result of some perceived or real manipulation which may result from the conflicts

of interest with issuer to market maker compensation arrangements. As it pertains to ETPs, STA believes that, given the derivative nature and efficient arbitrage mechanism of how ETPs are priced and trade, investors would continue to receive this intended protection if Rule 5250 were amended to no longer apply to market making activities in ETPs.

While STA believes that amending Rule 5250 would address a barrier to entry and have limited to no impact on its intended investor protections, we cannot definitely state that the barrier to entry is unreasonable. Some STA members believe there are other investor protections provided by the existing barriers to entry which need to be considered in making a determination of whether they are reasonable or not. These protections include potential harm to investors caused by an over proliferation of ETPs entering the market. An outcome such as this could expose investors to ETPs of lesser quality.

Some STA members are also concerned that a limited exemption which allows for, but does not require, payment will result in an industry de facto standard whereby all ETP issuers pay for market making services. In their opinion, such an outcome could result in a new barrier to entry and burden on competition. Finally, other STA members recommend regulatory attention would be better directed on reducing the costs to trade ETPs instead of implementing a limited exemption which allows for, but does not require, a payment.

STA therefore recommends that FINRA file a proposed amendment to Rule 5250 and explicitly solicit industry input on: existing barriers to entry and the investor protections they provide beyond those intended under Rule 5250; what harm to investors would result from an industry de facto standard whereby all ETP issuers paid for market making services; how FINRA can reduce those costs which an exemption to Rule 5250 seeks to address.

Unintended Consequences

So long as markets evolve, there will be unintended consequences from the legislation and regulation which governs them. Generally speaking, there are three (3) types of unintended consequences:

- Unexpected benefit, whereby the intended benefit was achieved and resulted in an unexpected benefit somewhere else.
- Unexpected drawback, whereby the intended benefit was achieved but resulted in an expected detriment somewhere else.
- Perverse result, whereby the solution made the problem worse.

Over time STA has developed certain principle-based guidelines which we believe limit unintended consequences that harm investors. These include:

- Incremental change is best. We have consistently recommended that rules and regulations be changed incrementally to better indentify and address any unintended consequences.
- The probability of unintended consequences is reduced when changes are made in stable markets and not times of financial market unrest.
- Regulatory infrastructures which can efficiently monitor for and eradicate unexpected drawbacks and perverse results need to exist.
- Retrospective reviews can identify changes, in particular those which were originally perceived as insignificant, which resulted in unintended consequences.

As it pertains to Rule 5250 and ETPs, STA believes that the described rule filing proposal is consistent with these guiding principles. A limited exemption with balanced disclosures represents an incremental change at a time when markets are stable. We also believe that the regulatory structure needed to efficiently monitor for and eradicate unexpected drawbacks and perverse results exists.

STA therefore recommends that FINRA file a proposed amendment to Rule 5250 and explicitly solicit industry input on the intended and unintended consequences with allowing for a limited exemption in the areas of competition and investor protection. Having this input will enable FINRA to determine how effectively it can monitor and eradicate unexpected drawbacks and perverse results.

Conflicts of Interest

Conflicts of interest have the ability to cause harm to investor confidence. Therefore, STA has recommended efficient monitoring of situations where a conflict exists and urges caution with allowing new conflicts into the market. STA also recognizes that while bans or prohibitions on arrangements where parties are conflicted have benefits; they can also be costly for investors because they eliminate choice.

Disclosure is an efficient means of managing conflicts of interest. If a conflict and its potential consequences are disclosed, then investors are better educated and able to make informed decisions. Disclosure is also a strong deterrent for conflicts of interest to exist because parties may choose to not engage in the conflicted behavior if doing so requires them to disclose they are.

STA approaches decisions on how to deal with conflicts of interest by taking a balanced approach and asking the following questions:

- What is the nature of the conflict?
- Is the conflict being disclosed?

- Is there a way to measure and therefore determine if parties are bending to the conflict? [10]
- Is there a means to prevent the parties from bending to the conflict?
- Would investors be better off if the conflict were removed/introduced?

STA recognizes and takes seriously that the limited exemption to FINRA Rule 5250 would introduce a conflict of interest into the market place. However, Rule 5250 is blunt and as we review the conflict of interest it seeks to address under the series of questions above, we believe this limited conflict should be allowed to exist under the following conditions:

Question #1. What is the nature of the conflict?

Answer #1. Payments or other consideration offered by issuers or other parties to induce a broker-dealer to make a market in the issuer's security raise the concern that the market maker will be influenced to quote the security because of the payments rather than the market maker's actual interest in the security.

Question #2. Is the conflict being disclosed?

Answer #2. Payments by ETP issuers for market making activity need to be disclosed so investors, their agents, and regulators are aware of the potential conflict raised by the payments. However, the level of disclosure needs to be balanced because inadequate levels will fail to protect investors and over-burdensome levels will achieve results similar to banning the behavior and thus denying investors choice. The disclosure standards and transparency established by the exchange administrated program ensured adequate information was provided to market participants and regulators. Disclosure standards suitable for direct market maker compensation arrangements will need to be developed.

Question #3. Is there a way to measure and therefore determine if the parties are bending to the conflict?

Answer #3. Yes, today ETP issuers, market makers and exchanges closely monitor ETP prices and how they track to the intrinsic value of their underlying securities. Therefore any nefarious behavior involving ETP prices by market makers who would receive direct payments would be immediately identifiable. STA believes these tracking mechanisms are efficient and will continue to exist if an exemption to Rule 5250 were granted.

[10] By "bending to the conflict," we mean the conflicted party, or parties, are acting in a self-serving manner that is detrimental to market integrity or investor protection.

Question #4. Is there a means to prevent the parties from bending to the conflict?

Answer #4. Yes, due to the derivative nature of ETPs, artificial prices which may be influenced by a market maker payment program and do not align with the market value of the underlying securities are quickly eradicated by other market participants because there is an economic gain that can be achieved through today's highly technologically advanced and interconnected market place. Additionally, ETP issuers are unlikely to influence artificial prices which would be classified as manipulation of their ETPs because such behavior would result in tracking error, making an issuer's ETP less desirable than those of their competitors.

Question #5. Would investors be better off if the conflict were removed/introduced?

Answer #5. Allowing a limited exemption to Rule 5250 would foster greater competition and provide a means to address costs and barriers to entry. Those two outcomes coupled with balanced disclosure and efficient regulatory oversight have historically provided benefits which accrue to investors. STA therefore believes that investors would be better off if the limited exemption to Rule 5250 with balanced disclosure were introduced.

STA therefore recommends that FINRA file a proposed amendment to Rule 5250 and explicitly solicit industry input on balanced disclosure requirements. For example, should the disclosure requirements for an ETP issuer who makes a one-time payment to a market making firm to cover initial trading costs be the same for an ETP issuer who makes continual payments which seek to promote market quality of the ETP.

Conclusion:

STA recommends that FINRA file a proposed amendment to Rule 5250 that would: (a) permit FINRA members to accept one or more payments from the issuer of an Exchange-Traded Product ("ETP") for purposes of acting as a registered market maker in the ETP; and (b) define suitable disclosure requirements for such market maker compensation arrangements. STA believes a formal rule filing and subsequent comment period would enable FINRA and the Commission to make a ruling on whether such a limited exemption serves investors well.

Mike Rask
Chairman of the Board

James Toes
President & CEO