Vanguard®

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January 29, 2018

Submitted electronically to pubcom@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
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. Mitchell:

Vanguard[1] appreciates the opportunity to provide our comments to the Financial Industry Regulatory Authority ("FINRA") on its retrospective rule review of Rule 5250 (Payments for Market Making) (the "Rule"). As of December 31, 2017, Vanguard was the sponsor of 71 U.S. exchange-traded funds ("ETFs") with collective assets of approximately $855 billion. We believe the Rule is generally functioning to achieve the purpose for which it was designed and that FINRA should not propose any changes to the Rule.

We share FINRA's historical concerns underlying regulation of issuer payments to market makers.[2] Consistent with its focus on protecting investors, FINRA has observed that payment for market making could give rise to a conflict of interest that inappropriately influences market making activities and harms investor confidence in the marketplace.[3] Further, FINRA has identified that payment for market making may prevent investors from determining which quotations arise from actual interest and which result from issuer payment.[4] In 2013, FINRA amended the Rule to permit payments expressly provided for under the rules of a

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[1] Vanguard is an SEC-registered investment adviser that offers more than 200 funds with aggregate assets of approximately $4.9 trillion.

[2] *See* Notice to Members 75-16 (February 1975) and Notice to Members 96-83 (December 1996).

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

[4] *See* Regulatory Notice 14-26 (June 2014).

national securities exchange (an "Exchange") that are effective after being filed with, or filed with and approved by the Securities and Exchange Commission ("SEC").[5]

Vanguard believes issuer payments to ETF market makers, while beneficial to market makers, could negatively impact ETF investors. Specifically, issuer payments to market makers have the potential to distort market forces, which could result in spreads and prices that do not reflect actual supply or demand. Such payments could also lead to diminished market making activity and wider spreads in ETFs that choose not to compensate market makers, and could create a pay-to-play environment by forcing issuers to pay to maintain quality markets for their ETFs. In such an environment, the costs associated with compensating market makers would be incorporated into the ETF's expense ratio and would be borne by the fund's shareholders, raising the cost of ownership.[6]

In response to Regulatory Notice 17-14, which requested comment on FINRA rules impacting capital formation, FINRA received a comment from an Exchange proposing that FINRA exempt exchange-traded products from the restrictions of the Rule entirely.[7] We would have significant concerns with any proposal to remove completely the prohibition in the Rule on receipt of compensation by member firms from ETF issuers. Prior to FINRA considering any such change to the application of the Rule, we believe that the SEC would need to work with the Exchanges to consider important policy questions relating to compensating ETF market makers. Prior to any such review of the Rule, the SEC should also work with the Exchanges to evaluate data relating to the effects of existing market maker incentive programs administered by the Exchanges and their utility for ETFs and investors. We also believe that it would be critical for FINRA to coordinate with the SEC and the Exchanges to study the impact that making such a change to the Rule could have on the ETF industry and ETF investors more broadly.

We note that, in addition to the Rule, there are other important legal and regulatory restrictions that would need to be considered as part of any regulatory effort to review whether market makers should be permitted to receive compensation directly from ETF issuers. For example, consideration would need to be given to anti-fraud manipulation provisions of the

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[5] FINRA Rule 5250(b)(3); Securities Exchange Act Release No. 34-63938 (April 18, 2013). Certain Exchanges adopted rules creating programs to compensate market makers subsequent to this amendment to the Rule. *See e.g.,* NASDAQ Rule 5950 and the NASDAQ Market Quality Program (MQP).

[6] These concerns are described in more detail within our comment letters to the SEC on prior proposals by certain Exchanges to create programs to compensate market makers. *See* Letter to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, from Gus Sauter, Managing Director and Chief Investment Officer, Vanguard, dated May 3, 2012; Letter to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, from Gus Sauter, Managing Director and Chief Investment Officer, Vanguard, dated June 7, 2012; and Letter to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, from F. William McNabb, Chairman and Chief Executive Officer, Vanguard, dated August 15, 2012.

[7] Letter to Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA, from Chris Concannon, President and COO, Cboe Global Markets, Inc., dated November 22, 2017.

Securities Exchange Act of 1934 and rules thereunder, including Rule 102 of Regulation M.[8] In addition, the SEC and FINRA would also need to consider how ETF sponsors and market makers would disclose the existence of direct compensation arrangements and related potential outcomes in a manner that would provide meaningful information to ETF investors.[9]

For the reasons set forth above, we believe the Rule is generally functioning to achieve the purpose for which it was designed and do not believe additional changes are warranted.

We appreciate the opportunity to comment on the Rule. If you have any questions about Vanguard's comments or would like any additional information, please contact Lance Barrett at 610-669-2616.

Sincerely,

/s/

Ryan Ludt
Global Head of ETF Capital Markets
Vanguard

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[8] 17 CFR 242.102. Rule 102 of Regulation M prohibits direct and indirect attempts to induce a bid for purchase of a covered security during the applicable restricted period.

[9] Section 17(b) of the Securities Act of 1933, in relevant part, makes it unlawful for any person to offer a security for sale without fully disclosing receipt of compensation received directly or indirectly from an issuer, underwriter or dealer of the security.