SECURITIES AND EXCHANGE COMMISSION

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REGULATION NMS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules and amendments to joint industry plans.

SUMMARY: The Securities and Exchange Commission ("Commission") is publishing Regulation NMS for public comment. In addition to redesignating the existing national market system ("NMS") rules adopted under Section 11A of the Securities Exchange Act of 1934 ("Exchange Act"), Regulation NMS would incorporate four substantive proposals that are designed to enhance and modernize the regulatory structure of the U.S. equity markets. First, the Commission is proposing a uniform rule for all NMS market centers that, subject to certain exceptions, would require a market center to establish, maintain, and enforce policies and procedures reasonably designed to prevent "trade-throughs"—the execution of an order in its market at a price that is inferior to a price displayed in another market. Second, the Commission is proposing a market access rule that would modernize the terms of access to quotations and execution of orders in the NMS. The third proposal would prohibit market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment finer than a penny, except for securities with a share price of below $1.00. Finally, the Commission is proposing amendments to the rules and joint industry plans for disseminating market information to the public that, among other things, would modify the formulas for

allocating plan net income to reward markets for more broadly based contributions to public price discovery.

DATES: Comments must be received on or before [insert date that is 75 days after date of publication in the Federal Register].

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by hard copy or e-mail, but not by both methods. Comments sent by hard copy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-10-04. Comments submitted by e-mail should include this file number in the subject line. Comment letters received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (http://www.sec.gov).[1]

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[1] Personal identifying information, such as names or e-mail addresses, will not be edited from electronic submission. Submit only information that you wish to make publicly available.

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I. Preliminary Statement

The Commission is publishing for public comment proposed Regulation NMS, which incorporates a set of four, broad substantive rule proposals on market structure, along with the procedural rule proposal to create Regulation NMS. We recognize that, if ultimately adopted, the rule proposals would effect fundamental innovations in the nation’s equity markets. Today’s action is intended to advance the dialogue on these vitally important market structure issues.

Giving the public an opportunity to comment on specific rule proposals is the logical next step in the deliberate and systematic review of market structure that the Commission has

undertaken in recent years. The central objective of this review is to determine how the regulations governing the U.S. equity markets should be modernized. Our markets are continually evolving because of such factors as innovative trading technologies, new market entrants, and changing investment patterns. We believe that one of our most important responsibilities is to monitor these changes and to ensure that the U.S. regulatory structure remains up to date. In this way, we can help our markets retain their position as the deepest and most efficient in the world – markets that offer a fair deal to all types of investors, large and small.

By publishing the proposals, the Commission does not intend to suggest that its market structure review is complete and that final decisions have been reached on any of the rule proposals' provisions. The issues undoubtedly are complex. Reaching good decisions requires a firm grasp of the relevant facts, an understanding of the often subtle ways in which the markets work, and the balancing of policy objectives that sometimes may not point in precisely the same direction. To inform its thinking, the Commission repeatedly has sought the views of market participants and the public. Thus far, our review has included multiple public hearings and roundtables, an Advisory Committee, four concept releases, the issuance of temporary exemptions intended in part to generate useful data on policy alternatives, and a constant dialogue with industry participants and investors. The information and data generated by these steps has formed the basis for the development of the rule proposals.

The Commission believes that focusing comment on specific rule proposals is the essential next step in achieving the best possible regulatory initiatives. In this regard, in addition to seeking written comments, we will hold one or more hearings in the coming months to expand

the opportunity for dialogue on the rule proposals themselves and on the issues they address. The Commission will reflect the insights gained from this open process in its final rulemaking.

II. Objectives for Rule Proposals

The Commission is publishing four substantive rule proposals that are designed to enhance and modernize the national market system, along with a procedural rule proposal to create a new Regulation NMS. The rule proposals include the following regulatory initiatives:

(1) a uniform trade-through rule for all NMS market centers that would affirm the fundamental principle of price priority, while also addressing problems posed by the inherent difference in the nature of prices displayed by automated markets, which are immediately accessible, compared to prices displayed by manual markets;

(2) a uniform market access rule with a de minimis fee standard that would help assure non-discriminatory access to the best prices displayed by NMS market centers, but without mandating inflexible, "hard" linkages such as the Intermarket Trading System ("ITS");

(3) a sub-penny quoting rule establishing a uniform quoting increment for NMS stocks to promote greater price transparency and consistency;

(4) amendments to the arrangements for disseminating market information that would reward self-regulatory organizations ("SROs") for their contributions to public price discovery, as well as implement many of the recommendations of the Commission's Advisory Committee on Market Information; and

(5) Regulation NMS, which would modernize and restructure the Exchange Act rules governing the NMS to promote greater clarity and understanding of the rules.

If adopted, the proposals collectively would constitute a significant upgrade of the NMS regulatory framework and address a variety of issues that have arisen in recent years. The NMS

needs to be enhanced and modernized, not because it has failed investors, but because it has been so successful in promoting growth, efficiency, innovation, and competition that many of its old rules now are outdated. Since the NMS was created nearly thirty years ago, trading volume has exploded, competition among market centers has intensified, and investor trading costs have shrunk dramatically. Each of the major milestones in the development of the NMS – including the creation of the consolidated system for disseminating market information in the 1970s, the incorporation of The Nasdaq Stock Market, Inc. ("Nasdaq") securities into the NMS in the 1980s, and the adoption of the Order Handling Rules in the 1990s – has successively generated enormous benefits for investors.

In the 2000s, improvements to the NMS have continued to benefit investors. In particular, the rescission of New York Stock Exchange, Inc. ("NYSE") Rule 390, trading in penny increments, and public disclosure of order execution quality have set the stage for exceptionally vigorous competition among market centers, particularly to provide the best prices for orders of less than block size (10,000 shares). Since November 2001, for example (the first month for which all markets were required to disclose their execution quality), the effective spreads paid by investors seeking liquidity in the NMS have declined steadily across all markets by a cumulative total of more than 40%.[2] In November 2003 alone, these reduced spreads resulted in cumulative investor savings of more than $340 million, or more than $4.0 billion on an annualized basis.[3] Importantly, small investors seeking direct participation in the U.S.

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[2] This 40% reduction in spreads since November 2001 is in addition to the reduction in spreads that occurred immediately upon the initiation of trading in penny increments in the first part of 2001. See infra, text accompanying notes 197-199.

[3] Using execution quality statistics publicly disclosed pursuant to Exchange Act Rule 11Ac1-5, investor savings are calculated based on the share volume of market and marketable limit orders with sizes of less than 10,000 shares that were executed at 23 NMS market centers in November 2003. The share volume for each stock is multiplied

securities markets have shared fully in these savings, and indeed likely have been the biggest beneficiaries of NMS improvements.

The proposals published for public comment today are intended to help assure that the NMS continues to serve investor interests in the future. The particulars of the proposals are described in more detail below. The balance of this overview places the proposals in the context of the Commission's historical approach to market structure and summarizes the goals that the proposals are designed to achieve.

The objectives for the NMS set forth in the Exchange Act are well known – efficiency, competition, price transparency, best execution, and direct interaction of investor orders. Each of these objectives is essential, yet they sometimes conflict with one another in practice and can require delicate balancing. In particular, the objective of market center competition can be difficult to reconcile with the objective of investor order interaction. We want to encourage innovation and competition by the many individual market centers that collectively make up the NMS, while at the same time assuring that each of these parts contributes to a system that, as a whole, generates the greatest benefits for investors – not their market intermediaries.

The Commission therefore has sought to avoid the extremes of, on the one hand, isolated market centers and, on the other hand, a totally centralized system that loses the benefits of vigorous competition and innovation among market centers. To achieve the appropriate degree of integration, the Commission primarily has relied on two tools: (1) transparency of the best prices through the consolidated display of quotes and trades from all NMS market centers; and (2) intermarket "rules of the road" that establish a basic framework within which competition

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by the difference in effective half-spreads between Nov. 2001 and Nov. 2003 in each stock at each market center.

among NMS market centers can flourish on terms that ultimately benefit investors. Today's proposals are intended to continue this strategy.

In particular, the proposals are designed to address a variety of problems that generally fall within three categories:

(1) the need for uniform rules that promote equal regulation of, and free competition among, all types of market centers;

(2) the need to update antiquated rules that no longer reflect current market conditions; and

(3) the need to promote greater order interaction and displayed depth, particularly for the very large orders of institutional investors.

A. Promote Equal Regulation of Market Centers

Not that many years ago, the NMS could be divided fairly clearly into groups of stocks, each with its own particular mix of market centers. The traditional auction exchanges – NYSE and the American Stock Exchange LLC ("Amex") – dominated trading in their listed stocks, with some dealer participation on the regional exchanges and in the third market. Market makers dominated trading in Nasdaq stocks.

Today, these historical divisions are disappearing. For Nasdaq stocks, automated quote-driven market centers (such as Nasdaq's SuperMontage, the Archipelago Exchange,[4] and Inet ATS, Inc. ("Inet")) have captured more than 50% of share volume. For Amex stocks (for which approximately 39% of share volume now is represented by two extremely active exchange-traded funds ("ETFs") -- the QQQ and SPDR), Amex now handles approximately 27% of the volume, with the remaining balance split among Archipelago, Inet, and others. The NYSE has

[4] The Archipelago Exchange ("Archipelago") is the equities trading facility of the Pacific Exhange ("PCX").

retained approximately 75% of the volume in its listed stocks, but other market centers are attempting to raise the level of competition and increase their share of trading. Moreover, the NYSE and Amex have sought to add automated facilities that are integrated with and complement their traditional exchange floors.

The intensified competition, or threat of competition, in the NMS in recent years has benefited investors by reducing trading costs and prompting better, more efficient services. The rules that govern the NMS, however, need to be updated to reflect the new market conditions. Many rules, for example, were developed separately for listed markets and the Nasdaq market. This disparity makes little sense today when the level of trading volume and the identity and character of participating market centers are becoming more similar for both listed and Nasdaq securities.

Section 11A(c)(1)(F) of the Exchange Act grants the Commission rulemaking authority to assure equal regulation of all markets for NMS securities. Today, in many respects, the same rules apply across all U.S. equity markets. For instance, all broker-dealers have an obligation to seek to obtain best execution for their customers' orders – specifically, to seek to obtain the most favorable terms available under the circumstances.[5]

In other respects, however, there is disparity in rules across markets, and the Commission believes the proposals set forth in Regulation NMS will help further the statutory objective of assuring equal regulation of all markets for NMS securities. For example, the market for listed

[5] The Commission recognizes that execution price and speed of execution are not the sole relevant factors in obtaining best execution of investor orders, and that other factors may be relevant, such as (1) the size of the order, (2) the trading characteristics of the security involved, (3) the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information, and (4) the cost and difficulty associated with achieving an execution in a particular market center.

securities currently has a trade-through rule affirming the principle of price priority, while the market for Nasdaq securities does not. The proposed trade-through rule would address this disparity. In addition, certain market centers currently charge substantial fees for access to their displayed quotes, while other market centers are not permitted to assess such charges. The proposed access rule would address this disparity. Finally, some market centers currently engage in sub-penny quoting, while others do not. The proposed sub-penny rule would establish a uniform quoting convention.

B. Update Antiquated Rules

The NMS was created in the 1970s. Although the fundamental policy objectives that guided its creation remain as valid as ever, some of the NMS rules and facilities no longer adequately address current market conditions. For example, some were written long before technological innovation opened the door for new types of services, such as automatic execution and order routing services.

The proposals would modernize older NMS rules that have become antiquated. The proposed market access rule, for example, could be implemented using indirect market linkages that have been enabled by improved communications technology, rather than a hard linkage like the one incorporated into the ITS. The market data proposal would update formulas for allocating income to the SROs that were adequate many years ago when a single market dominated each group of securities, but much less so now when volume is split among different market centers whose contributions to the public quote and trade streams can vary considerably.

C. Promote Greater Order Interaction and Displayed Depth

A significant strength of the current NMS is the competition among market centers that encompass a variety of trading models, from traditional exchanges to electronic communications

networks ("ECNs") with automated limit order books to automated market maker systems. This competition particularly has benefited retail investors, for whom a primary component of execution quality is spread costs.

Conversely, perhaps the most serious weakness of the NMS is the relative inability of all investor buying and selling interest in a particular security to interact directly in a highly efficient manner. Little incentive is offered for the public display of customer orders – particularly the large orders of institutional investors. If orders are not displayed, it is difficult for buying and selling interest to meet efficiently. In addition, the lack of displayed depth diminishes the quality of public price discovery.

The seriousness of this weakness has been voiced frequently in recent years by institutional investors. For large institutional orders (generally greater than 10,000 shares and often substantially greater), price impact costs are a more significant component of execution quality than spread costs. For example, assume that an institution decides to sell 100,000 shares of a stock when the best bid is $20, but winds up selling the stock for an average price of $19.80 because the price declines in response to the institution's selling interest. In this case, the 20-cent per share price impact cost is likely to greatly exceed the spread costs in the stock that are associated with smaller orders. Institutional investors have indicated that they need more effective ways to interact directly with large size trading interest on the other side of the market. The limited data on institutional trading costs that is publicly available tends to support their complaints. For example, one recently published analysis of worldwide institutional trading

costs found that such costs for NYSE and Nasdaq stocks rose, respectively, by 25.1% and 29.6% for the period from 1999 through the second quarter of 2003.[6]

A variety of factors other than market structure (such as the decline in average stock prices) could be significant contributors to an increase in institutional trading costs. Nevertheless, these costs appear to have risen substantially during the same time period that smaller order execution costs have dropped dramatically. Given the troubling nature of this trend, we cannot afford to be satisfied with the status quo as regards the efficiency of the NMS. A critically important goal of the proposals is to enhance opportunities for the direct interaction of investor buying and selling interest and to improve the depth of public price discovery.

For example, the trade-through proposal, by modifying the existing listed market trade-through rule to accommodate the differing nature of quotes displayed by manual and automated markets, is intended to assist those institutions that seek direct and efficient interaction with contra trading interest. Similarly, the market access proposal would help assure that all investors have non-discriminatory access to the best prices for a security, no matter where they are displayed in the NMS. The sub-penny quoting proposal would address the practice of "stepping-ahead" of displayed limit orders for trivial amounts, which disadvantages those investors who are willing to contribute to quoted depth by publicly displaying their trading interest. Finally, the central objective of the market data proposal is to reward those market centers whose quotes reflect the best prices for the largest sizes and thereby contribute the most to public price discovery.

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[6] Justin Schack, "Trading Places," Institutional Investor, Nov. 2003 at 29, 32 (citing Elkins/McSherry analysis).

III. Trade-Through Proposal

A. Executive Summary

Changes in the equities markets in recent years have raised the issue of whether a trade in one market should be executed when a quote at a better price is displayed in another market. Rules limiting trading at an inferior price have been in place since 1978 in the markets for NYSE and Amex securities, but no such intermarket rules exist in the markets for Nasdaq securities. Over the years, dramatic changes have occurred in each of these markets, and trading in Nasdaq, NYSE, and Amex securities has spread across an increasing variety of market centers, including "alternative" highly automated markets, many of which provide for almost instantaneous executions of matching buy and sell orders within their systems. Various markets, including the NYSE, Amex, and Nasdaq, have deployed new automation systems to make their markets more efficient. Moreover, advances in technology have led to sophisticated order routing and execution systems that can provide extremely fast routing and execution capabilities among competing multiple markets. Finally, the minimum pricing variation in equity securities is now a penny instead of an eighth, resulting in narrower spreads, at least for many actively traded stocks. At the same time there is decreased depth at the best quote, and rapid quote changes - often many times within a second.

The Commission believes that these changes require it to revisit the issue of trading at inferior prices across markets.[7] Clearly, in a fully efficient market with frictionless access and instantaneous executions, trading through a better-displayed bid or offer should not occur. Yet the Commission believes that even in the current markets with linkages between markets and a range of execution speeds and fill rates, there is value in protecting a displayed price from trades

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[7] See Section III.B.2.b. infra for a discussion of the current ITS trade-through rule.

occurring at inferior prices in other markets. This "price protection" encourages the display of priced orders and fosters the execution of customer orders.

The Commission therefore is proposing a rule intended to preserve the benefits of price protection across markets, while addressing the tensions in the operation of the current ITS trade-through rule. The proposed rule would require an order execution facility (as defined below), national securities exchange, and national securities association to establish, maintain, and enforce polices and procedures reasonably designed to prevent the execution of a trade-through in its market. The proposed rule would apply to all incoming orders in "NMS Stocks" – all Nasdaq, NYSE, and Amex-listed stocks - and to any order execution facility that executes orders internally within its market, whether or not that market posts its best bid and offer in the consolidated quote system.[8]

The proposed rule would have two major exceptions. One would allow customers (and broker-dealers trading for their own accounts) to "opt-out" of the protections of the rule by providing informed consent to the execution of their orders, on an order-by-order basis, in one market without regard to the possibility of obtaining a better price in another market. The other exception would take into account the differences between the speed of execution in electronic versus manual markets by providing an automated market with the ability to trade-through a non-automated market up to a certain amount away from the best bid or offer displayed by the non-automated market. The Commission believes that the proposed rule would promote competition and order interaction between markets, provide an incentive for the use of limit orders and

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[8] "NMS Stock" is defined proposed Rule 600 of Regulation NMS to mean any NMS Security other than an option. NMS Security is defined in proposed Rule 600 of Regulation NMS to mean any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan.

aggressive quoting, facilitate the ability to achieve best execution and help reduce the effects of fragmentation.

B. Background and Discussion

1. Foundation of Our National Market System

Amendments to the Exchange Act made almost three decades ago formed the basis for the modern market structure in the U.S. – a national market characterized by a system of competing markets, rather than one centralized market. Section 11A of the Exchange Act, enacted as part of the Securities Act Amendments of 1975 ("1975 Amendments"), sets forth Congress' findings regarding the nation's securities markets and directs the Commission to facilitate the development of an NMS in keeping with the principles set forth by Congress.[9] Specifically, Congress found that it is in the public interest and appropriate for the protection of investors and the maintenance of a fair and orderly market to assure:

- the economically efficient execution of securities transactions;
- fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
- the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
- the practicability of brokers executing investors' orders in the best market; and
- the opportunity, consistent with the provisions in the first and last bullets above, for investors' orders to be executed without the participation of a dealer.[10]

Congress also found that the linking of all markets for securities will "foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the

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[9] Section 11A(a)(2) of the Exchange Act, 15 U.S.C. 78k-1(a)(2).

[10] Section 11A(a)(1)(C) of the Exchange Act, 15 U.S.C. 78k-1(a)(1)(C).

offsetting of investors' orders, and contribute to best execution of such orders."[11] In short, Section 11A of the Exchange Act envisions a market structure characterized by full transparency where competing markets are linked together to provide the ability to effectively and efficiently execute customer orders in the best available market. It is these core principles that have shaped the Commission's actions to foster the development of a true NMS.

Although Congress set out broad principles to govern the development of an NMS, it did not dictate a specific form that it should take. Instead, Congress envisioned that competitive forces, to the extent feasible, would shape the structure of our markets, and granted the Commission broad authority to oversee the implementation, operation, and regulation of an NMS.[12] In keeping with Congress' mandate, the Commission believes that its central role is to facilitate the development of an NMS, not to dictate the precise form that the NMS will take.[13]

Within the framework of this philosophy, the Commission has over the years helped to guide the development of our NMS. For instance, the Commission, working with the various SROs, has taken numerous steps to implement the basic structure upon which our existing NMS is built. For example:

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[11] Section 11A(a)(1)(D) of the Exchange Act, 15 U.S.C. 78k-1(a)(1)(D).

[12] See Securities Exchange Act Release No. 14416 (January 26, 1978), 43 FR 4354 (February 1, 1978) ("1978 Statement") at 12-13, 17-18. See also Senate Committee on Banking, Housing and Urban Affairs, Report to Accompany S. 249, S. Rep. No. 94-75, 94th Cong., 1st Sess. (1975) ("Senate Report") at 7-9 and Comm. of Conference, Report to Accompany S. 249, H.R. Rep. No. 94-249, 94th Cong., 1st Sess. (1975) ("Conference Report") at 50-51, 92.

[13] In its status report on the state of the national market system in 1979, the Commission stated that its role in the development of a national market system is to "monitor and encourage industry progress, to act as a catalyst and, when necessary, to take regulatory action to achieve a particular goal. However, the Congress did not intend that the Commission dictate the ultimate configuration of the national market system or, through regulatory fiat, force all trading into a particular mold." Securities Exchange Act Release No. 15671 (March 22, 1979), 44 FR 20360 (April 4, 1979) ("1979 Status Report") at 3.

- In the late 1970s the Commission issued several policy statements outlining its vision of an NMS, including a belief in the importance of attaining nationwide protection for customer limit orders.[14]

- In the late 1970s the Commission adopted a rule requiring the exchanges and the National Associations of Securities Dealers ("NASD") to report quotations in certain securities, and approved an NMS plan established by the SROs relating to the reporting of quotations in exchange-listed securities (the Consolidated Quotation or "CQ" Plan).[15]

- Rule 11Aa3-1 (proposed to be designated as Rule 601), which requires SROs to implement a transaction reporting plan for the collection, processing and dissemination of last sale transaction reports in reported securities, was adopted in 1972.[16]

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[14] See, e.g., 1978 Statement, supra note 12, at 35-38 and 1979 Status Report, supra note 13, at 10-18.

[15] See Securities Exchange Act Release Nos. 14415 (January 26, 1978), 43 FR 4342 (February 1, 1978) (adopting Rule 11Ac1-1 under the Exchange Act). Rule 11Ac1-1 (proposed to be designated as Rule 602) requires each SRO to collect, process and make available to securities information vendors quotation prices and sizes for all securities as to which last sale information is included in the consolidated transaction reporting system contemplated by Rule 11Aa3-1 under the Exchange Act (proposed to be designated as Rule 601). In 1978 the Commission approved a joint proposal by the SROs to implement the requirements of Rule 11Ac1-1 under the Exchange Act (proposed to be designated as Rule 602), the CQ Plan, which became effective on July 28, 1978. See Securities Exchange Act Release No. 15009 (July 28, 1978), 43 FR 34851 (August 7, 1978). On February 20, 1979 quotations of third market makers were added to the consolidated quote data stream. See Securities Exchange Act Release No. 15511 (January 24, 1979), 44 FR 6230.

[16] See Securities Exchange Act Release No. 9850 (November 8, 1972), 37 FR 24172 (the rule was adopted as Rule 17a-15 and was redesignated as Rule 11Aa3-1 in 1980). In the mid 1970s the Commission approved two NMS plans proposed by various SROs to implement the requirements of Rule 11Aa3-1. See Securities Exchange Act Release Nos. 10787 (May 10, 1974), 39 FR 17799 (approving a joint plan proposed by the NYSE, Amex, Midwest Stock Exchange (the predecessor to the Chicago Stock Exchange ("CHX"), Pacific Exchange ("PCX"), PBW Stock Exchange (the predecessor to the Philadelphia Stock Exchange ("Phlx")) and the NASD, which became the Consolidated Tape Association ("CTA") Plan) and 11255 (February 18, 1975), 40 FR 8397 (declaring effective individual plans proposed by the Boston Stock Exchange ("BSE"), Cincinnati Stock Exchange (the predecessor to the National Stock Exchange ("NSX")), Detroit Stock Exchange and Instinet for complying with Rule 11Aa3-1 subject to each becoming an "other reporting party" pursuant to the CTA Plan). The Commission notes that the current CTA Plan participants are: Amex, BSE, Chicago Board Options Exchange

- In 1979 the Commission approved an exchange plan to link the various markets trading exchange-listed securities (the "ITS Plan").[17]

- Rule 11Ac1-2 (proposed to be designated as Rule 603), which was adopted in 1980, imposes minimum requirements regulating the manner in which securities information vendors display transaction and quotation information.[18]

- In response to the Commission's continuing concerns regarding intermarket price protection, in 1981 the ITS participants proposed amendments to the ITS Plan and to their own rules requiring participants to avoid the execution of a trade at a price worse than the best price displayed on another participant market.[19] In 1981 the Commission approved the amendments to the ITS Plan, including a model trade-through rule upon which the SRO trade-through rules were based.[20] In 1981 and 1982, respectively, the Commission approved the exchanges' and NASD's trade-through rules.[21]

("CBOE"), CHX, NSX, NASD, NYSE, PCX and Phlx. See Securities Exchange Act Release No. 48987 (December 23, 2003), 68 FR 75661 (December 31, 2003).

17 See Securities Exchange Act Release Nos. 14661 (April 14, 1978), 43 FR 17419 (April 24, 1978) (initial temporary approval), 15058 (August 11, 1978) (extending temporary approval), 16214 (September 21, 1979), 44 FR 56069 (extending temporary approval) and 19456 (January 27, 1983), 48 FR 4938 (February 3, 1983) (final permanent approval). All national securities exchanges and the NASD are now members of the ITS Plan except the International Securities Exchange, which trades solely securities not covered by the ITS Plan. The ITS Plan requires each Plan participant to provide electronic access to its displayed best bid or offer to other Plan participants and provides an automated mechanism for routing orders, called commitments, to reach those displayed prices.

18 See Securities Exchange Act Release No. 16590 (February 13, 1980), 45 FR 12391 (February 19, 1980).

19 See Securities Exchange Act Release Nos. 17703 (April 9, 1981) (adopting amendments to the ITS Plan), 17579 (February 26, 1981), 46 FR 14876 (March 2, 1981) (CHX proposal), 17612 (March 9, 1981), 46 FR 16770 (March 13, 1981) (PCX, BSE, NYSE and Phlx proposal) and 17671 (March 30, 1981), 46 FR 20345 (April 3, 1981) (NSX and Amex proposal).

20 See Securities Exchange Act Release No. 17703 (April 9, 1981), supra note 19.

21 See Securities Exchange Act Release Nos. 17704 (April 9, 1981), 46 FR 22520 (April 17, 1981) (order approving exchange rules) and 19249 (November 17, 1982), 47 FR 53552 (November 26, 1982) (order approving NASD rule).

- In 1990 the Commission approved on a pilot basis a proposal by several of the SROs governing the collection, consolidation and dissemination of quotation and transaction information for Nasdaq national market securities listed and traded on Nasdaq and traded on exchanges pursuant to unlisted trading privileges.[22] The Nasdaq UTP Plan now applies to all Nasdaq securities.[23]

- In 1996, as part of its Order Handling Rules initiative designed to enhance transparency and competition in the market place, the Commission adopted Rule 11Ac1-4 under the Exchange Act (proposed to be designated as Rule 604) (the "Limit Order Display Rule"), which requires certain exchange specialists and over-the-counter ("OTC") market makers to publicly display customer limit orders that better the specialist's or market maker's displayed price and/or size.[24]

- The Commission also amended Rule 11Ac1-1 under the Exchange Act (proposed to be designated as Rule 602) (the "Quote Rule") at the same time to require a specialist or OTC market maker to publicly display its best-priced quotations and customer limit orders for any listed security when it is responsible for more than 1% of the aggregate trading volume for that security, and to make publicly available any superior prices that the specialist or market maker privately quotes through certain ECNs.[25]

- In June 2000 the Commission issued an order that established the framework for the SROs to convert their quotation prices from fractions to decimals.[26] The order allowed the SROs to select a uniform minimum pricing variation for stock quotes of no greater than $.05 and no less than $.01.[27] In July 2000 the SROs submitted a

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22 See Securities Exchange Act Release No. 28146 (June 26, 1990), 55 FR 27917 (July 6, 1990) (approval order of the Reporting Plan for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis ("Nasdaq UTP Plan")). The parties did not begin trading until July 12, 1993; thus, the pilot period began on July 12, 1993. The Nasdaq UTP Plan has been in operation since that time on an extended pilot basis. See, e.g., Securities Exchange Act Release Nos. 34371 (July 13, 1994), 59 FR 37103 (July 20, 1994) and 48318 (August 12, 2003), 68 FR 49534 (August 18, 2003).

23 See Securities Exchange Act Release No. 45081 (November 19, 2001), 66 FR 59273 (November 27, 2001) (extending the scope of the Plan to include all Nasdaq/NM and SmallCap securities).

24 See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996).

25 Id.

26 See Securities Exchange Act Release No. 42914 (June 8, 2000), 65 FR 38010 (June 19, 2000).

27 Id. at 38013.

> Decimals Implementation Plan that set the minimum pricing variation for equity stock quotations at one cent, and each SRO established rules setting the minimum quoting increment for equity securities in its market at one cent.[28]

These and other actions resulted in a solid foundation for our NMS. For NYSE, Amex, and Nasdaq securities, the best bids and offers of each national securities exchange and registered OTC market maker are collected and made available to market participants. The last sale prices for NYSE, Amex, and Nasdaq securities are collected and disseminated through a central reporting facility to market participants. All national securities exchanges and registered OTC market makers that trade "ITS eligible" securities (including any ECN registered as an Intermarket Trading System/Computer Assisted Execution System ("ITS/CAES") market maker) are able to access each ITS participant's top-of-book through the ITS linkage, and are subject to existing trade-through provisions that require ITS participants' members to seek to avoid trading at a price in one market that is inferior to the price displayed in another market. Alternative markets to the traditional floor-based auction markets have developed within the existing national market system, bringing added competition to our markets.

2. Intermarket Price Protection

The Commission believes that one of the most important goals of an NMS is the encouragement of the display of limit orders and aggressive quotes, which provide the basis for all price discovery in the markets. When trades occur at prices that are inferior to displayed limit orders or quotes, it could discourage their display because market participants may be less willing to display limit orders or to quote aggressively if they believe it likely that such orders and quotes will be bypassed by executions in other markets at prices that would be advantageous to them. A rule that effectively prevents one market from executing an order at a price that is

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[28] See Securities Exchange Act Release No. 46280 (July 29, 2002), 67 FR 50739 (August 5, 2002).

inferior to a better price displayed on another market, especially in an NMS characterized by multiple competing markets, may encourage market participants to use limit orders and to quote aggressively, which in turn can improve the price discovery process and contribute to increased liquidity and depth. Moreover, such a rule, coupled with adequate access among markets, also could help reduce the effects of fragmentation and promote order interaction among competing markets by providing that trades would not execute in each individual market without reference to quotes and orders displayed in other markets.

In addition, when trades occur at prices worse than the displayed quote, it gives an impression of unfairness in our market system, especially to retail investors who see their orders executed at the inferior prices. Trade-through rules facilitate broker-dealers' ability to achieve best execution for their customers' orders. Pursuant to a trade-through rule, if a broker-dealer routes an order to a market that is not showing the best bid or offer at the time of order execution, that market should not execute the order at a price that is inferior to the price displayed on the other market, unless an exception applies.

a. History of Intermarket Price Protection

In the late 1970s, following the adoption of the 1975 Act Amendments to the Exchange Act, the Commission expressed its desire to move forward to achieve nationwide protection for customer limit orders, calling for industry efforts to be concentrated on achieving nationwide protection of public limit orders based on the principle of price priority.[29] With regard to the

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[29] See 1978 Statement, supra note 12, at 34-38 and 1979 Status Report, supra note 13, at 11-15. In its 1978 Statement, the Commission's focus included a desire for a central limit order file that would have provided price and time priority for public limit orders across markets trading the same securities. In its 1979 Status Report, however, the Commission recognized that introducing a system based upon absolute intermarket time priority for public limit orders might have a disruptive impact on the nation's markets at that time.

trading of exchange-listed securities, the Commission believed that the ITS participants should be given time to enhance ITS as a way of providing intermarket price protection for customer limit orders.[30] Although its focus was on providing protection for public limit orders, in its 1979 Status Report the Commission also stated its belief that nationwide price protection, if it was to be accomplished "in a fair manner consistent with the Act," ultimately should protect all buying and selling interest displayed by a market center as part of its current bid and offer as well as all displayed public limit orders away from the best market that were also superior to the price of the proposed trade.[31]

In 1981 the participants in the ITS Plan proposed amendments to the ITS Plan that stated that certain market participants should not execute orders at a price worse than the best price displayed by another participant market in the public quote.[32] The proposal included a model

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The Commission thus expressed its intent to focus attention on achieving intermarket price priority for public limit orders.

30 See 1979 Status Report, supra note 13, at 15-16. In 1979 the Commission proposed, as a step towards achieving intermarket price protection for public limit orders through ITS, its own rule that would have prohibited a broker-dealer from executing a transaction in a market center at a price inferior to the price of any displayed public limit order(s) unless the broker-dealer either simultaneously with or immediately after such execution satisfied any better priced public limit order. See Securities Exchange Act Release No. 15770 (April 26, 1979), 44 FR 26692. In 1992, citing the passage of the years and the lack of progress on developing a nationwide system for the collection and dissemination of limit orders, the Commission withdrew its proposed rule. See Securities Exchange Act Release No. 31344 (October 21, 1992), 57 FR 48581 (October 27, 1992) ("Withdrawal Release"). In doing so, it noted that the trade-through rules of the SROs, while not providing the same level of intermarket price protection that would have been provided by the Commission's rule, did provide price protection for public limit orders. Id. at 12.

31 See 1979 Status Report, supra note 13, at 25.

32 See Securities Exchange Act Release No. 17703 (April 9, 1981), supra note 19 (order adopting trade-through amendments to the ITS Plan), and Section 8(d) of the ITS Plan.

trade-through rule.[33] The Plan participants also proposed amendments to their own rules to institute trade-through rules patterned after the model ITS rule requiring their members to avoid trading through a better price displayed on another market.[34] In 1981 the Commission approved these amendments to the ITS Plan and ITS exchange participant trade-through rules.[35] Several years later, the NASD become an ITS Plan participant and instituted its own trade-through rule that applies to each of its members that is a registered market maker in exchange-listed securities (an "ITS/CAES" market maker).[36]

b. Existing Intermarket Price Protection Regime

The NYSE and Amex markets, and the Nasdaq market, have adopted different approaches to intermarket price protection. With regard to NYSE- and Amex-listed securities, the ITS trade-through rule requires members of an exchange, when purchasing or selling, either as principal or agent, a security traded through ITS on the exchange or by issuing a commitment to trade through ITS, to avoid initiating a trade-through (unless an exception applies).[37] The ITS

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33 See Exhibit B of the ITS Plan.

34 See supra note 19. The ITS participants also proposed to develop a "limit order information system" ("LOIS"), based on the existing ITS, that would have required specialists to aggregate and enter limit orders for display, and brokers executing a block trade outside the best bid or offer would have been required to satisfy the LOIS orders. This system was never implemented because of the participants' inability to reach consensus. See Withdrawal Release, supra note 30, at 10-11.

35 See Securities Exchange Act Release No. 17703 (April 9, 1981), supra note 19 (approval of trade-through amendments to ITS) and 17704 (April 9, 1981), supra note 21 (approval of exchange trade-through rules).

36 See Securities Exchange Act Release No. 19249, supra note 21 (approval of NASD trade-through rule). The basic operation of the NASD's trade-through rule is similar to that of the exchange trade-through rules.

37 See Section (b)(1) of Exhibit B of the ITS Plan. Pursuant to the ITS Plan and SRO trade-through rules, an ITS Participant can send an order, termed a "commitment to trade," to another ITS Participant to trade with a better price displayed by that other Participant

rule defines a trade-through to occur when a member initiates a purchase (sale) on the exchange of a security traded through ITS at a price that is higher (lower) than the price at which the security is offered (bid for) at the time of the purchase (or sale) in another ITS participant market as reflected in the offer (bid) then being displayed on the exchange from the other participant market.[38] Each SRO requires its members, when purchasing or selling any ITS security, either as principal or agent, on its market or when sending a commitment through ITS, to avoid initiating a trade-through unless an exception applies.[39] The SRO trade-through rules also include extensive procedures for "satisfying" an order that is traded-through.[40]

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market. The commitment to trade is a firm obligation to trade for a fixed period of time, either 30 seconds or one or two minutes, depending upon the time period chosen by the sending ITS Participant. If the receiving ITS Participant accepts the commitment to trade, the system reports back an execution to the sending ITS Participant. If the commitment to trade is not accepted by the receiving ITS Participant within the specified time frame, the commitment is automatically canceled. A commitment to trade also may be canceled by the receiving ITS Participant within the designated time period if it is priced away from the receiving ITS Participant's market at the time the commitment is received.

38 The ITS rule also defines a trade-through to occur when a member of the exchange initiates the purchase (sale) of a security traded through ITS by sending a commitment to trade through ITS that results in an execution at a price that is higher (lower) than the price at which the security is being offered (bid for) at the time of the purchase (sale) in another ITS participant market as reflected by the offer (bid) then being displayed on the exchange from such other order execution facility. See Section (a) of Exhibit B of the ITS Plan.

Section 8(d)(i) of the ITS Plan states that members located in an ITS exchange participant market or an ITS/CAES market maker should not purchase (sell) any security that is traded through ITS at a price that is higher (lower) than the price at which the security, at the time of the purchase, is offered (bid for) by one or more of the other Participants' markets, as reflected in the offer (bid) being furnished from the other market that is available on the trading floor of, or available in the quotation service used by, such member or ITS/CAES market maker.

39 See, e.g., NYSE Rule 15A and NASD Rule 5262. The exceptions to the existing SRO trade-through rules include the following circumstances: (1) when the size of the bid or offer traded-through is for 100 shares; (2) the member that initiated the trade-through is unable to avoid the trade-through because of a systems/equipment failure or malfunction;

The existing trade-through rules apply to exchange members and registered OTC market makers that trade NYSE or Amex-listed securities, but not to block positioners that operate in the OTC market without registration as OTC market makers.[41] Thus, OTC block positioners generally are not restricted by the existing trade-through rule from trading outside the best bid

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(3) the transaction that constituted the trade-through was not a "regular way" contract; (4) the bid or offer that was traded-through was being displayed from a market that was relieved of its obligations with respect to the bid or offer under Rule 11Ac1-1 under the Exchange Act pursuant to the "unusual market" exception of paragraph (b)(3) of that rule; (5) the trade-through occurred on an exchange during a period when the members on the exchange were relieved of their obligations under paragraph (c)(2) of Rule 11Ac1-1 pursuant to the "unusual market" exception of paragraph (b)(3) of Rule 11Ac1-1, provided, however, that unless one of the other exceptions applies, during such period members shall make every reasonable effort to avoid trading-through any bid or offer displayed on the exchange from any other ITS Participant whose members are not so relieved of their firm quote obligations under paragraph (c)(2) of Rule 11Ac1-1; (6) the bid or offer traded-through had caused a locked or crossed market in the security; (7) the transaction involves purchases and sales effected in an opening (or reopening) transaction; and (8) the transaction involves any "block trade" or "block transaction" as defined in the SRO's ITS block trade policy.

Each SRO has adopted a policy regarding the execution of block trades, based on a model block trade policy contained in Exhibit C of the ITS Plan, that allows a member (or ITS/CAES market maker, in the case of the NASD) to trade-through a better displayed price on another market in the course of executing a block trade if the member simultaneously executes the better displayed order at the block price. See, e.g., NYSE Rule 15A and NASD Rule 5264.

40 In summary terms, the market whose order was traded-through must first send a complaint to the market that initiated the trade-through. The party that initiated the trade-through must then respond, either by claiming an exception or by taking corrective action. If corrective action is taken, the party that traded-through can either satisfy the order that was traded-through at the limit price (or, in limited circumstances, at the price that caused the trade-through) or adjust the price of the transaction that caused the trade-through to a price at which the trade-through would not have occurred. In all instances where an order that was executed was for an account other than the account of the broker-dealer involved, the order shall receive either: (i) the price that caused the trade-through; (ii) the price at which the order traded-through was satisfied; or (iii) the adjusted price, whichever is most beneficial to the order. See, e.g., NYSE Rule 15A(b)(2)(A), (B) and (C) and NASD Rule 5262(b)(1) and (2).

41 Block positioners are exempt from the 1% mandatory quote requirement of the Quote Rule, Rule 11Ac1-1 under the Exchange Act.

and offer. Nor do the trade-through rules apply to alternative trading systems ("ATSs") that trade NYSE or Amex-listed securities in the OTC market unless they are required to (or choose to) post quotes in the consolidated quotation system through an SRO.[42] When an ATS displays its best bid or offer in the consolidated quotation system through an SRO, it becomes subject to that SRO's trade-through restrictions (and thus the ITS Plan trade-through restrictions). For example, the NASD requires any ATS that intends to display its quotes in NYSE or Amex securities in the OTC market to register as an ITS/CAES market maker and thus become subject to the NASD's (and ITS Plan's) trade-through restrictions.[43]

In contrast, the Nasdaq UTP Plan as approved by the Commission does not contain any trade-through provisions, and no intermarket trade-through rules currently exist with regard to the trading of Nasdaq securities.[44]

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[42] Specifically, pursuant to Regulation ATS, ATSs are not required to display their best bid and offer in a particular security through an SRO until they have 5% or more of the average daily trading volume in that security over a six-month period. See Section 301(b)(3)(i) and (ii) of Regulation ATS, 17 CFR 242.301 to 303.

[43] A market maker or ATS that intends to or is required to display quotes in NYSE or Amex securities in the consolidated quotation system and chooses to do so through the NASD through the Consolidated Quotations Service ("CQS") must register with the NASD as a CQS market maker. See NASD Rule 6320(a). Any CQS market maker that is registered in a reported security that is eligible for inclusion in ITS/CAES also must register as an ITS/CAES market maker and must participate in ITS/CAES. See NASD Rules 6320(e) and 5210(e). ITS/CAES enables market makers in ITS-eligible securities to direct orders to, and receive orders from, other ITS participant markets.

[44] In its 1985 release announcing its decision to grant unlisted trading privileges to national securities exchanges in NMS Securities, the Commission noted that it did not believe that a sophisticated intermarket linkage needed to be in place during the initial stages of trading such securities, but it encouraged the NASD and exchanges to develop computerized intermarket trading linkages and trade-through rules on their own. See Securities Exchange Act Release No. 22412 (September 16, 1985), 50 FR 38640. In subsequent releases, the Commission reiterated its belief that UTP participants should develop an intermarket trading linkage and adopt a trade-through rule. See Securities Exchange Act Release No. 31672 (December 30, 1992), 58 FR 3054 (January 7, 1993) and 33408 (December 30, 1993), 59 FR 1045 (January 7, 1994).

c. Strains on Existing Intermarket Price Protection Regime

While the Commission continues to believe that a trade-through rule can encourage the use of limit orders, facilitate best execution, and reduce the effects of fragmentation, the Commission is concerned that developments in the markets over the last few years have called into question the continued viability of the existing system for achieving intermarket price protection in NYSE and Amex stocks.

The structure of the U.S. securities market is quite different now than when the ITS trade-through provisions were adopted. At the time when the existing rules were put in place, order routing and execution facilities were slower, there was less vigorous intermarket competition in NYSE, Amex, and Nasdaq securities, and the minimum trading increment was 1/8th of a dollar. By contrast, in today's market, rapid advances in technology have provided a variety of means to efficiently route orders to multiple markets. "Alternative" markets that provide almost instantaneous executions by automatically matching buy and sell orders have emerged, as has the use of "smart" order routing and execution systems by broker-dealers and other market participants. Stocks are quoted in pennies instead of 1/8ths, which has led (in many instances) to narrower spreads, less depth at the top-of-book and rapidly changing quotes. It also may reduce the cost of a trade-through to the investor.

Because competing market centers currently offer different speeds and levels of certainty of execution, the challenge of providing price protection across these diverse markets has grown. In recent years some market participants have argued that the restrictions imposed by existing trade-through rules for NYSE and Amex securities impede the efficient operation of "non-traditional" automated markets that operate by automatically, and nearly instantaneously,

matching buying and selling interest resident in their systems.[45] These market participants say that if an electronic market is subject to existing trade-through rules, the market must slow down or forego an execution in its system in order to send an order to another market displaying a better price to attempt to access that better priced order, or risk having to satisfy the better-priced order if it is traded-through. Although the trade would occur at an inferior price, these market participants say that some customers prefer the speed and/or certainty of execution over price.

Many automated markets argue that requiring them to provide this outbound access to a non-automated market to reach the better price displayed on that other market, no matter how marginal that better price is and how long it takes the other market to execute the order (if at all), not only compromises the basic structure of their markets but also effectively grants an option to that slower market during the time period before the order is executed. This option has value, as there is a risk that the market for the stock may move before the order is executed, especially if a significant amount of time passes before the order is executed.[46] In addition, market participants argue that there is no guarantee that the order will even be executed at the price that was showing at the time that the order was sent, given the rapid quote changes that exist for some securities today.[47]

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45 These arguments have been made in various forums including congressional hearings, industry publications, and discussions with regulators.

46 Pursuant to the ITS Plan, an entity sending a commitment through the ITS system may designate a time period during which the commitment shall be irrevocable following acceptance by the system – either thirty seconds or one or two minutes. See Section 6(b)(i) of the ITS Plan and Securities Exchange Act Release No. 44903 (October 3, 2001), 66 FR 52159 (October 12, 2001). If the commitment is not accepted or rejected during the applicable time period, the commitment is automatically canceled by the system at the end of the applicable time period. See Section 6(b)(iv) of the ITS Plan.

47 The Commission notes that many industry participants have expressed frustration with so-called "phantom quotes," where a market participant is unable to interact with another market's quote because the quote faded upon receipt of the order. The Commission

A trade-through rule like the current ITS trade-through rule effectively prevents a market center from executing an investor's order immediately at an inferior price, even if that is what the investor desires. Thus, such a rule impacts an individual investor's ability to direct the manner in which its order will be executed. In today's environment characterized by rapidly changing quotes, narrow spreads, and less depth at the inside, some investors may believe that best execution is fulfilled by instructing their broker that speed and/or certainty of execution is more important than the possibility of a small amount of price improvement.

With respect to transactions in certain high-volume, derivatively-priced ETFs – QQQs, SPDRs and Diamonds – that are widely traded by electronic markets, the Commission in August 2002 issued an order to ease the restrictions of the trade-through rules by granting, on a temporary basis, a three-cent de minimis exemption to the trade-through provisions of the ITS Plan.[48] The exemption allows participants to execute orders in these ETFs at prices no more than three cents away from the best bid or offer displayed in the consolidated quote at the time of execution.[49] The Commission, in issuing the exemption, stated its belief that the exemption

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reminds markets that the firm quote rule requirements in Rule 11Ac1-1 under the Exchange Act apply to all incoming orders, including ITS commitments, and stresses that it is the responsibility of each market participant that is posting a bid or offer to comply with the rule, and each SRO's responsibility to effectively and consistently enforce compliance by its members with the rule. See, e.g., Securities Exchange Act Release No. 40260 (July 24, 1998), 63 FR 40748 (July 30, 1998) (stating the firm quote rule applies to ITS commitments and emphasizing that all ITS participants must strictly enforce the rule to ensure that investors receive best execution and that the market receives reliable quotation information).

[48] See Securities Exchange Act Release No. 46428 (August 28, 2002), 67 FR 56607 (September 14, 2002).

[49] Id. The Commission has extended this temporary exemption until March 4, 2004. See Securities Exchange Act Release No. 47950 (May 30, 2003), 68 FR 33748 (June 5, 2003).

would, on balance, provide investors with increased liquidity and increased choice of execution venues while limiting the possibility that investors would receive significantly inferior prices.[50]

In light of the Commission's three-cent de minimis exemption for the QQQs, SPDRs, and Diamonds, the ITS participants held many discussions regarding ways to revise the trade-through requirements in the ITS Plan. The participants were not able to reach consensus on a course of action (amendments to the ITS Plan must be unanimous under the existing plan provisions). The Commission also notes that not all market participants affected by the operation of the current trade-through rules have a direct voice in the administration of the ITS Plan, and are therefore unable themselves to directly influence or affect any changes to the trade-through provisions of the ITS Plan.

With respect to the market for the trading of Nasdaq securities, there are no intermarket trade-through rules and no mandatory intermarket linkage other than the telephonic access required among markets trading Nasdaq stocks under the Nasdaq UTP Plan and the access requirements for participants in the NASD's Alternative Display Facility ("ADF").[51] Over the past few years, however, a number of new markets have begun trading Nasdaq stocks. Nasdaq

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[50] Id. The Commission's Office of Economic Analysis conducted an analysis of trading in the QQQs in 2002, comparing trading on a day before the de minimis exemption was implemented; a day after the exemption was implemented before the Island ECN stopped displaying its orders to anyone, even its subscribers (going "dark"); and a day after the exemption was implemented when the Island ECN was "dark." The analysis showed that the percent of trades executed outside the NBBO did not increase, and that less than 1% of total trades were executed more than three cents away from the NBBO, after the de minimis exemption was implemented. A copy of the analysis is available in the File No. S7-10-04.

[51] In general, the ADF access rules provide that any market participant quoting in the ADF must provide (1) direct electronic access to all other ADF quoting market participants, and (2) direct electronic access to any other NASD member broker-dealer that is not an ADF quoting market participant, if requested, and must allow for indirect electronic access. See NASD Rule 3400A(a).

stocks are traded on Nasdaq's National Market Execution System (more commonly known as "SuperMontage"), all of the largest ECNs, the PCX (through its equity trading facility the Archipelago Exchange), the Amex, the BSE, and the NSX. In addition, Nasdaq stocks are traded among participants in the ADF. Nasdaq market makers and other registered broker-dealers also continue to trade Nasdaq securities outside of SuperMontage or the ADF. As a result, trading now extends beyond the Nasdaq's SuperMontage system where displayed prices are protected. Broker-dealers trading in the Nasdaq market rely on best execution obligations. Yet, even without a trade-through rule, the Nasdaq market does not appear to lack competitive quoting in the most actively traded securities.

C. Proposed Trade-Through Rule

The Commission believes there is value in having a rule that provides a measure of price protection for limit orders across markets, if the rule is designed to accommodate the current structure of our NMS. Like the current ITS trade-through rule, a Commission trade-through rule would encourage the use of limit orders, aggressive quoting, and order interaction and help preserve investors' expectation that their orders will be executed at the best displayed price. The Commission therefore is proposing its own trade-through rule that would apply not only to the trading of NYSE and Amex securities but also to the trading of Nasdaq securities.

The Commission's proposed trade-through rule would require markets, with regard to the trading of NMS Stocks - NYSE, Amex, and Nasdaq securities - to establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of trade-throughs in their markets. The proposed rule includes two exceptions to the basic requirement that are designed to address issues that have been raised regarding the current ITS trade-through rule. One exception would allow customers (and broker-dealers acting for their own account) to

provide informed consent to having their orders executed in one market without regard to prices in other markets. The other exception would allow an automated market to trade through a non-automated market up to a certain amount. The proposed rule is intended to respond to the current criticisms of the existing rule and accommodate different marketplace models, while still preserving important customer and market integrity protections. As discussed in more detail in Section III.C.7. below, the Commission emphasizes that the proposed rule is not intended to, and would not, in any way alter or lessen a broker-dealer's best execution obligations.

1. Markets Subject to the Proposed Rule

The proposed rule would require an order execution facility,[52] national securities exchange and national securities association to establish, maintain, and enforce policies and procedures reasonably designed to prevent the purchase or sale of an NMS Stock at a price that is inferior to a better price displayed on another market.[53] The intent of the proposed rule is to prohibit the execution of any trade-through by any order execution facility, national securities association or national securities exchange, absent one of the specified exceptions. Nevertheless, the Commission recognizes the unavoidable "false-positive" and "false-negative" trade-throughs that occur because quotes are updated and orders are executed more rapidly than information can be communicated. The Commission does not believe that an order execution facility should be

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[52] An order execution facility would be defined in proposed Rule 600 of Regulation NMS as any exchange market maker; OTC market maker; any other broker or dealer that executes an order internally by trading as principal or crossing orders as agent; ATS; or national securities exchange or national securities association that operates a facility that executes orders.

[53] The proposed definition of a "trade-through" would be the purchase or sale of an NMS Stock during regular trading hours, either as principal or agent, at a price that is lower than the best bid or higher than the best offer of any order execution facility that is disseminated pursuant to an effective national market system plan at the time the transaction is executed. See proposed Rule 600 of Regulation NMS.

held responsible for protecting a better-priced quote that it cannot see because it has not yet received the quote. Specifically, in an environment where quotes can change numerous times within a fraction of a second, an order execution facility should not be required to protect a best bid or best offer of another order execution facility disseminated within the same second during which the order execution facility executed the order but which was not the best bid or best offer that the executing market saw at the instant that it executed the order. The Commission requests comment on whether drafting the rule to require order execution facilities, national securities exchanges, and national securities associations to establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of trade-throughs in their markets is sufficient to effectively deter and prevent trade-throughs. Should the Commission instead, or in addition, explicitly prohibit trade-throughs absent an exception?

The Commission is proposing to define "order execution facility" broadly to include all national securities exchanges and national securities associations that operate a facility that executes orders, ATSs, exchange specialists and market makers, OTC market makers, block positioners and any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.[54] The Commission believes that including broker-dealers that do not post quotes or orders in the public quote but that nevertheless execute orders internally is important because otherwise those markets would have an advantage over markets that display their best quotes and orders in the public quote. Given the availability of best bid and best offer

[54] See Rule 600 of proposed Regulation NMS. The Commission notes that the proposed definition of order execution facility would include any registered broker-dealer that is a member of an SRO that executes orders internally, as an OTC market maker, exchange specialist or market maker, block positioner, or otherwise. In addition, however, the Commission is proposing that an order execution facility, national securities exchange, and national securities association may choose to accept only "opted-out" orders (as discussed below) and, therefore, would not be required to comply with the requirements of the proposed rule. See section (a)(2) of proposed Rule 611 of Regulation NMS.

information, the access standards proposed by the Commission today,[55] and the advanced technology that currently is available for the routing of order flow, the Commission does not believe that including "non-quoting" markets within the scope of the proposed rule would impose any undue hardships on such markets. The Commission requests comments on the advisability of including "non-quoting" markets within the scope of the rule, including whether there are any practical difficulties or other costs that would not justify the benefits of requiring them to comply with the rule. The Commission also requests comment on the extent of any positive or negative impact of including these markets within the scope of the rule.

2. Types of Securities Subject to the Proposed Rule

The proposed trade-through rule would apply to the trading of all NMS Stocks, which means that it would apply to the trading of all Nasdaq, NYSE, and Amex stocks.[56] Applying a trade-through rule to the trading of Nasdaq securities would represent a change from the status quo. The Commission believes that it may no longer be possible to identify a distinction between Nasdaq stocks and other NMS Stocks for purposes of imposing trade-through protections.

The Commission requests comment on applying the protections of the proposed rule to the trading of Nasdaq securities. The Commission also requests comment on the practical impact of implementing a trade-through rule for Nasdaq securities, including specifically what system, technical, or other changes would be needed to implement the proposed rule.

3. Types of Orders Subject to the Proposed Rule

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55 See Section IV infra for a discussion of the Commission's market access proposal.

56 See note 8, supra.

The proposed rule would apply to any purchase or sale of an NMS Stock during regular trading hours. Accordingly, the proposed rule would apply to orders for the account of a broker-dealer as well as for the account of a customer.[57] The Commission believes that excluding orders for the account of a broker-dealer would undermine the purpose of the proposed rule to provide price protection to displayed better-priced limit orders and quotes, because the broker-dealer orders would be able to trade-through the better prices. However, a broker-dealer (as well as a customer) may choose to opt-out of the rule's protections with regard to orders for its own account, pursuant to the opt-out exception proposed below. The Commission requests comment on whether broker-dealer orders should be included within the scope of the rule.

4. Bids and offers to Be Protected

The proposed rule would require an order execution facility, national securities exchange, and national securities association to establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of an order at a price that trades through the best bid or best offer of any order execution facility that is disseminated pursuant to an effective national market system plan. Currently, bids and offers that are disseminated pursuant to an effective national market system plan include, with respect to NYSE and Amex listed securities, the best bid and best offer of each national securities exchange that trades a particular NYSE or Amex listed security, as well as the best bid and best offer of each individual registered market maker and ATS (registered as an ITS/CAES market maker) that provides its best bid and best offer to the NASD for a particular NYSE or Amex listed security.[58] The current ITS trade-

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[57] For purposes of the proposed rule, "customer" is defined to mean any person that is not a broker or dealer. See proposed Rule 600 of Regulation NMS.

[58] See Rule 11Ac1-1 under the Exchange Act (proposed to be designated as Rule 602), 17 CFR 240.11Ac1-1, and Sections I(w) and VI(a) and (c) of the CQ Plan.

through rule protects the best bid and best offer of each national securities exchange and the "ITS/CAES BBO,"[59] which is one best bid price and one best offer price (with aggregate size) for all ITS/CAES market makers, but not the best bid and best offer of each individual ITS/CAES market maker.[60] With regard to the trading of Nasdaq securities, bids and offers that are disseminated pursuant to an effective national market system plan include the best bid and best offer of each national securities exchange that trades a particular Nasdaq security, the best bid and best offer of each registered Nasdaq market maker or ATS that provides its best bid and best offer in a particular Nasdaq security to Nasdaq, and the best bid and best offer of each ADF quoting market participant that provides its best bid and best offer in a particular Nasdaq security to the NASD.[61]

The Commission requests comment on the extent to which the best bid and best offer of each individual market maker and ATS that would be protected pursuant to the proposed rule is available to all order execution facilities that would be subject to the proposed rule, and the extent to which the accessibility of those bids and offers would be impacted by the proposed access standards and market data amendments proposed today.[62] The Commission also requests comment as to the scope of the bids and offers that should be protected pursuant to the proposed

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59 The ITS/CAES BBO is defined in Section 6(a)(i)(B) of the ITS Plan as the best bid price and best offer price, together with the sum of the sizes accompanying the bids and offers at the best bid price and best offer price. The trade-through rule excepts bids and offers where the size is 100 shares.

60 See Sections 6(a)(i)(A) and (B) and 8(d)(i) of the ITS Plan, and e.g., NYSE Rule 15A(a)(2) and NASD Rule 5210(i).

61 See Securities Exchange Act Release No. 49137 (January 28, 2004), 69 FR 5217 (February 3, 2004) (notice of filing of amendments to the Nasdaq UTP Plan).

62 See infra Sections IV and VI, respectively, for a discussion of the Commission's market access proposal and the market data proposal.

rule. In particular, should the best bids and best offers of each individual registered market maker and ATS be protected, as proposed? Or should the proposed rule protect only the best bid and best offer of each national securities exchange and the aggregate best bid and best offer of each non-exchange "market" (i.e. one best bid price and one best offer price with aggregate size for all ITS/CAES market makers with respect to the trading of NYSE and Amex securities otherwise than on an exchange, a best bid price and best offer price with aggregate size for the Nasdaq market with respect to the trading of Nasdaq securities, and a best bid price and best offer price with aggregate size for the ADF with respect to the trading of Nasdaq securities)? Further, if the proposed rule did not protect the best bid and best offer of each individual market maker and ATS, the Commission requests comment as to whether there should be just one best bid price and best offer price, with aggregate size, for the trading of Nasdaq securities other than on an exchange, or whether there should be a separate best bid and best offer for trading on Nasdaq and a separate best bid and best offer for trading on the ADF.

As noted above, the proposed rule would apply only to the best bid and best offer of any order execution facility that is disseminated pursuant to an effective national market system plan. It would not apply to other limit orders or quotes that are also priced better than the order being executed but are not disseminated pursuant to an effective national market system plan. To expand the price protection beyond the best bid and best offer for each market would entail the Commission requiring quoting market centers to make available, and provide access to, their entire depth of book to other markets. Although the Commission believes that from a policy viewpoint it would make sense to provide protection to any better-priced quote or order displayed in another quoting order execution facility, not just the top-of-book of each quoting order execution facility, the Commission questions whether protecting all displayed limit orders

and quotes at this time would be feasible. The Commission, however, requests comment on whether it should expand the scope of the proposed rule to include trade-through protection beyond the best-displayed bid and offer. For example should the scope of the proposed rule include protection beyond the best displayed bid and offer in the circumstance where a market center voluntarily provides depth-of-book information through the facilities of an effective national market system plan?

Current SRO rules regarding block trades in NYSE and Amex securities, adopted pursuant to the ITS Plan (as well as the provisions of the ITS Plan itself) allow block trades to be executed at an inferior price as long as the party executing the block executes any better priced order(s) displayed on another market(s) at the block price.[63] In the proposed rule, the Commission is not proposing to treat large "block-sized" trades any differently than non-block trades. Thus, an order execution facility could not execute a block trade at a price inferior to the best bid or offer displayed on any other order execution facility unless the order execution facility sent an order to trade at the price of the better-priced order.[64] The Commission believes that an exception for block trades may not be necessary because its proposed exception to the trade-through rule to allow a customer, or broker-dealer trading for its own account, to provide

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63 For purposes of the ITS participants' block trade policies, a "block trade" or "block transaction" is defined as a transaction that involves 10,000 or more shares of a common stock traded through ITS or a quantity of such stock having a market value of $200,000 or more that (i) is effected at a price outside the bid or offer displayed from another ITS participant market and (ii) involves either a cross of block size or any other transaction of block size that is not the result of an execution at the current bid or offer on the market executing the block trade. See, e.g., NYSE Rule 15A and NASD Rule 5264.

64 See Section III.D.3. below for a discussion of a proposed exception to the trade-through requirements in those instances where an order execution facility sends an order to execute against a better-priced order displayed on another market at the same time or prior to executing an order in its own market at an inferior price.

informed consent to having its order executed without the protection of the rule would be available to a customer or broker-dealer that wishes to execute a block trade.[65]

The Commission requests comment on whether this is the appropriate way to handle block trades under the proposed rule. The Commission requests comment on the extent to which treating block trades in the same manner as other trades, combined with the proposed opt-out exception, would impact a broker-dealer's or customer's ability to execute a block trade, if at all. The Commission also requests comment on whether a block exception would be necessary if the proposed opt-out exception were not adopted.

5. Required Policies and Procedures

The proposed rule would require each order execution facility, national securities exchange, and national securities association to develop policies and procedures reasonably designed to prevent the execution of a trade-through in its market.[66] While the exact nature and extent of the policies and procedures would therefore depend upon the type, size, and nature of the order execution facility, national securities exchange, and national securities association, these procedures must be designed to forestall trade-throughs from occurring other than pursuant to an exception. Among other things, the policies and procedures of an order execution facility, national securities exchange, and national securities association should provide for the monitoring of quotations in other markets and prevent a trade from being effected in its market at

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65 See Section III.D.1. below for a discussion of the proposed opt-out exception.

66 The Commission notes that any member of an SRO that executes orders would be deemed on order execution facility under the proposed rule and thus subject to the proposed rule's requirements. In addition, any member that would not be deemed an order execution facility but receives order flow from customers or other broker-dealers would potentially be subject to the proposed requirement to obtain informed consent prior to allowing the customer or broker-dealer to opt out.

a price inferior to a bid or offer that was apparent to the order execution facility in another market.

The Commission believes it is important for each order execution facility, national securities exchange, and national securities association to include a reasonable process in its required policies and procedures for specifically identifying and handling "false positive" and "false negative" trade-throughs. Given the speed with which the quotes update in certain stocks, there may well be instances of "false-positive" trade-throughs, where a market participant took all reasonable precautions and legitimately did not think it was trading through the best bid or best offer of any other market center disseminated pursuant to an effective national market system plan at the time of execution but, because of rapid-fire quote changes in the stock (or possibly inconsistent records as to the time of execution), it appears in hindsight that the order execution facility did in fact trade through another market. As discussed above, the Commission does not believe it reasonable to require a market center to protect a bid or offer that has not yet been received by it and that the market center, therefore, cannot see at the instant that an order is executed. The Commission recognizes that these issues already exist under the current trade-through rules. The Commission requests comment on specific procedures that could be implemented to prevent and identify instances of "false-positive" and "false-negative" trade-throughs.

The Commission also requests comment on the minimum standards to which an order execution facility, national securities exchange, and national securities association should adhere when establishing, maintaining, and enforcing its required policies and procedures

6. Access Standards

The Commission recognizes that it would not be reasonable to impose trade-through restrictions that prohibit an order execution facility from executing an order at a price inferior to the best bid or offer displayed in another market(s) unless the order execution facility can see and have fair and efficient access to those prices. Therefore, the Commission believes that an effective linkage between markets must be in place before implementing a trade-through rule, whether it is a "hard-wired" linkage or required minimum access standards. This is especially true for the market for Nasdaq stocks, where trading has expanded to multiple markets and where there is no existing "hard-wired" linkage or minimum access standards, other then the telephonic access required by the Nasdaq UTP Plan and the minimum access standards of the ADF.[67]

The Commission believes that the access standards it has proposed today would provide the necessary levels of access.[68] The Commission requests comment on whether existing access in the markets for Nasdaq, Amex and NYSE securities is adequate to support the proposed trade-through rule, in light of the advances in technology and the proprietary linkages already in place today. If current access is not adequate, the Commission requests comment on what access standards would be needed as a prerequisite to implementing the proposed trade-through rule.

Under the proposed access rules, an SRO would not be permitted to post quotes or orders for another market center (such as an ATS or market maker) through its facilities unless it has first made a determination that the market center has provided adequate access to its quotes and

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[67] For many years, only Nasdaq and the CHX traded Nasdaq stocks. Recently, as discussed in Section III.B.2.c. above, other markets have begun trading Nasdaq securities. While Nasdaq and CHX have negotiated a bilateral linkage between their markets, it is not clear how the other markets would be linked, if at all. The NMS plan governing the trading of Nasdaq securities, the Nasdaq UTP Plan, only requires telephonic access between the markets trading Nasdaq stocks. See Section IX of the Nasdaq UTP Plan.

[68] See Section IV infra for a discussion of the Commission's market access proposal.

orders under the proposed access standards.[69] The Commission believes that this requirement is necessary to protect against inaccessible markets becoming part of the consolidated quote.

7. Duty of Best Execution

The Commission emphasizes that the proposed trade-through rule, including the automated market exception, in no way alters or lessens a broker-dealer's duty to achieve best execution for its customers' orders. A broker-dealer still must seek the most advantageous terms reasonably available under the circumstances for all customer orders. A broker-dealer must carry out a regular and rigorous review of the quality of market centers to evaluate its best execution policies, including the determination as to which markets it routes customer order flow. A broker-dealer cannot merely assume that because the market(s) to which it sends its customer orders is subject to the proposed rule, the broker-dealer can abdicate its responsibilities for evaluating the execution quality of that market. Moreover, broker-dealers that execute customer orders internally would continue to be evaluated against the best bid and offer (or better bid or offer, if available) for best execution purposes, regardless of whether these orders were executed automatically or manually. The proposed trade-through rule does not justify a market maker executing retail orders internally at prices inferior to the best quote, even if executed automatically.

D. Exceptions to the Proposed Rule

To provide flexibility for market centers with different market structures and to give investors more control over how their orders are executed, the proposed rule would include an exception allowing customers to "opt-out," and an exception allowing an automated market to trade through a non-automated market in limited circumstances. The Commission also is

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[69] See Section IV.B.2. infra.

seeking comment on an alternative to these exceptions that would require market centers to provide automated access to displayed quotations.

1. Opt-Out Orders

Some investors may, at times, value speed and/or certainty of execution over the possibility of obtaining a slightly better price on another market, especially prices that may be as little as one cent per share better. These investors may want the ability to trade immediately in the market to which they send an order without having any delay from routing the order to another marketplace with a slightly better price, particularly a non-automated market that does not provide the same speed or certainty of execution as the market to which the investor sent its order. Such order routing decisions by an investor are facilitated by execution data now available for orders of less than 10,000 shares that can help guide investors in their investment decisions regarding where and when to execute their orders.[70] Large traders may also want the ability to execute a block immediately at a price outside the quotes, to avoid parceling the block out over time in a series of transactions that could cause the market to move to an inferior price.

A further benefit of providing investors with the flexibility to choose whether their orders should trade through a better quote is that it might create market forces that would discipline markets that provided slow executions or inadequate access to their markets. If investors were not satisfied with the level of automation or service provided by a market center, they could

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[70] Rule 11Ac1-5 under the Exchange Act (proposed to be designated as Rule 605), requires certain market centers to make publicly available on a monthly basis standardized statistics concerning their order executions, including such measures as the effective and realized spreads, speed of execution and the number of orders executed at, inside and outside of the quote. Rule 11Ac1-6 under the Exchange Act (proposed to be designated as Rule 606), requires broker-dealers to make publicly available on a quarterly basis a report on their order routing practices, including a discussion of any payment for order flow arrangements.

choose to have their orders executed without regard to that market's quote, thus putting pressure on the market to improve its services.

The Commission therefore is proposing an exception to the trade-through rule to allow an order execution facility to execute an order at a price that trades through a better-displayed bid or offer on another market if the person for whose account the order is entered (e.g. a broker-dealer for its own account or a customer for the customer's account) makes an informed decision to affirmatively opt out of the trade-through rule's protections with regard to that order.[71] The proposed exception strives to preserve the usual customers' expectation of having their orders executed at the best displayed price, but allows a choice for those investors whose trading strategies may benefit from an immediate execution priced outside the national best bid and offer ("NBBO"). Broker-dealers, of course, would not have to permit their customers the ability to opt out of the trade-through rule's protections. The Commission requests comment on whether the proposed opt-out exception is needed to enable informed traders to design their own trading strategies appropriate to their particular circumstances.

While the opt-out exception would provide greater execution flexibility to informed traders, the Commission recognizes that the opt-out exception is inconsistent with the principle of price protection for limit orders because it would allow investors to choose to have their orders executed without regard to better-priced orders displayed on other market centers. If limit orders frequently remain unexecuted after trades take place at inferior prices, investors may be

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[71] See Section (b)(8) of proposed Rule 611. A broker-dealer sending orders to another broker-dealer with whom it has a relationship (e.g. an introducing/executing broker relationship) would either be acting for its own account or acting on behalf of the account of a customer. In either instance, the broker-dealer receiving the orders would be required to obtain consent from the sending broker-dealer with respect to each order prior to treating an order as one that has "opted out." If the sending broker-dealer were acting on behalf of a customer, it would have to obtain informed consent from its customer prior to sending an order to another broker-dealer for execution.

discouraged from entering limit orders, thus reducing price discovery. In light of this concern, the Commission requests comment on the extent to which limit orders would remain unexecuted after a trade-through, and the impact on investors' use of limit orders, if the opt-out exception were to be implemented.

If used frequently, the proposed opt-out exception also might undermine investor confidence that their orders will receive the best price available in the markets, when they see trades frequently occurring at prices inferior to better prices displayed on other markets. The Commission therefore requests comment on whether the opt-out exception would undermine the principle of price priority and, if so, the anticipated impact of this exception on the principle of price priority.

a. Request for Comment on Automated Execution Alternative

To the extent that the need for trade-through flexibility is caused by the inability to trade efficiently with published quotations, this problem could be addressed more directly by requiring all market centers to provide an automated response to electronic orders at their quote. As discussed in Section IV below, the Commission historically has not dictated the means of execution provided by competing market centers. Nonetheless, if the Commission were to adopt an automatic execution requirement, such action may allay to some extent investors' concerns over their inability to quickly access manual markets and control their own executions.

In addition, to the extent that trade-through flexibility is needed to facilitate block trading, an automatic execution requirement in conjunction with the proposed trade-through rule's provision for simultaneously routing and trading may enable block trades to avoid trading through without moving the market. Because the proposed trade-through rule would allow a market participant to route orders to the displayed quotes and then trade at a price that would

otherwise be a trade-through, a block trader could use automatic execution to simultaneously access the existing displayed quotes and then execute the remainder of the block at a discount, without violating the rule.

An automatic execution requirement may well deal with two of the potential serious flaws with the proposed opt-out exception. First, to the extent that the opt-out exception is inconsistent with the principle of price protection for limit orders, an automatic execution requirement at the best bid or offer for limit orders avoids this problem. Under such an alternative, investors would not be discouraged from entering limit orders, and price discovery would be enhanced.

Second, an automatic execution alternative also supports the principle of price priority. It would not allow trades to occur at inferior prices, as could happen under the proposed opt-out exception. Such an alternative could maintain investor confidence that their orders will receive the best bids and offers displayed in any market.

For these reasons, the Commission requests comment on whether there is a continued need for the opt-out exception if it were to adopt an automatic execution requirement. The Commission also requests comment if there is a continued need for the proposed automated market exception, if the Commission were to adopt an automatic execution requirement, because all market centers would be required to provide the same basic level of automatic execution functionality, and thus there would be no distinction for purposes of the proposed rule between manual markets and automated markets.

In the access discussion in Section IV, the Commission requests comment on whether, if it were to require automatic execution, it would need to set performance standards governing the use of the automatic execution functionality to which all markets would be required to adhere.

The Commission specifically requests comment as to whether it should set minimum execution performance standards that would require that market participants' systems respond to orders from other markets within certain time frames.[72] Would minimum performance standards be essential to any consideration to not adopt an opt-out exception? The Commission also requests comment on whether, as discussed earlier, even if the Commission were to adopt an automatic execution requirement, the Commission should retain the proposed opt-out exception in order to provide a market and competition-driven incentive for different markets to provide and maintain a high level of service.

b. Opt-Out - Order-by-Order Consent

If a broker or dealer were to provide investors the ability to opt out, the proposed rule would require the broker-dealer to obtain informed consent from each investor who chooses to opt out of the protections of the proposed rule on an order-by-order basis. The Commission is not proposing to allow consent on a global basis, either by a written agreement or otherwise, because of a concern with the potential for abuse if consent can be obtained on a basis other than for each particular order. Requiring an investor to provide informed consent on an order-by-order basis, based upon its execution preference at the time of placing the order, is intended to help protect against less sophisticated customers, such as retail customers, consenting without fully understanding to what they are consenting or the effect of such consent. Specifying whether or not the order is "opted-out" could become another facet of the order handling instructions given to the broker-dealer at the time of execution, and indeed consent could be obtained electronically for those systems where orders are sent electronically to broker-dealers.[73]

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[72] See Section IV.A.2. infra.

[73] The Commission notes that if the ability to consent were automated, just as with non-automated consent, the broker-dealer should, consistent with any fiduciary

Nonetheless, in view of the time involved in communicating the consent, the Commission requests comment on the anticipated impact of the requirement to obtain informed consent on an order-by-order basis on the order handling and execution processes of each broker-dealer, and whether this requirement would be expected to significantly slow down that process. The Commission also requests comment on whether it is necessary to restrict consent to a trade-by-trade basis for parties that enter into agreements authorizing opting out, and if so, how such global consent should operate. Finally, the Commission requests comment on whether the ability to opt out should be available only to institutional or sophisticated investors, who may be better qualified, or in a better position to understand, the implications of opting out then retail investors. If so, how should the Commission define an institutional or sophisticated investor?

The requirement to obtain informed consent in order to allow an opt-out would apply to any broker-dealer that receives order flow from a customer or another broker-dealer even if that broker-dealer would not be considered an order execution facility under the proposed rule.[74] Although the way in which a broker-dealer would obtain informed consent consistent with any fiduciary obligations arising from the particular relationship with an investor may differ from investor to investor, a broker-dealer at a minimum should explain in clear and concise terms to any customer from whom it accepts consent, for each order, that: (1) the customer's order would be executed in the market to which it is sent without regard to prices displayed in other markets,

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responsibilities arising from the particular relationship with a customer or broker-dealer, provide each customer or broker-dealer submitting an order with sufficient clear and concise disclosure regarding the impact of such consent prior to the customer or broker-dealer making a determination whether or not to opt-out for each order to allow the customer or broker-dealer to make an informed decision. The broker-dealer also should provide a mechanism for ensuring that the customer fully understands the disclosure prior to making the determination whether to opt-out.

[74] The Commission reminds broker-dealers that they would be required to comply with the recordkeeping requirements of Rule 17a-4 under the Exchange Act, 17 CFR 240.17a-4.

even if those prices are better; (2) the customer affirmatively would be agreeing to forego the possibility of obtaining a better price that may be available in another market at the time its order is executed; and (3) this could result in the customer's order receiving an execution at a price that is inferior to the best bid or offer displayed at the time his or her order is executed. Each time a customer consents, the broker-dealer must be confident that the customer fully understands this disclosure and the nature of the consent. The Commission solicits comment on whether there are any particular disclosures that a broker-dealer should be required to make prior to obtaining informed consent.

The Commission requests comment on how a broker-dealer would fulfill this obligation to obtain informed consent with respect to orders it receives from other broker-dealers, when it has no interaction or relationship with that broker-dealer's customers. The Commission also requests comment on how, if at all, broker-dealers would fulfill this obligation with respect to retail customers who lack complete information about comparative market quality, current market data from all markets, and the willingness to undertake individual market routing decisions. Further, the Commission requests comment on whether different issues are raised when an order execution facility receives order flow directly from customers for execution.

The Commission realizes that market participants that handle customer or broker-dealer orders and that choose to provide these entities the ability to opt out likely would have to make changes to their order handling and execution practices to accommodate this exception. Likewise, an order execution facility receiving the order from another order execution facility, a broker-dealer, or directly from a customer for execution would need to ensure that its systems could distinguish between opted-out and non-opted-out orders for purposes of execution. Broker-dealers receiving orders from their customers and other broker-dealers likely would need

to amend their order handling procedures to accommodate those who choose to opt out, as well as their own orders for which the broker-dealer opts out. The Commission requests comment on order handling, systems and other changes broker-dealers that route orders, and order execution facilities that execute orders, would have to make before they would be able to implement the requirements of this proposed exception.

c. Opt-Out - Provision of National Best Bid or Offer

The Commission also is proposing to require a broker-dealer to disclose to its customers that have opted-out the national best bid or offer, as applicable, at the time of execution for each execution for which a customer opted out.[75] If the order were a purchase, the broker-dealer would be required to provide the national best offer at the time of execution and if the order were a sale, the broker-dealer would be required to provide the national best bid at the time of execution.[76] Such disclosure would be required to be given as soon as possible, but in no event later than one month from the date on which the order was executed. The bid or offer that would be required to be disclosed to the customer pursuant to this exception would need to be displayed in close proximity to, and no less prominently than, the execution price for the applicable

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[75] See section (c) of proposed Rule 611. The Commission is not proposing to require a broker-dealer to provide this information to another broker-dealer from which it receives order flow. Specifically, a broker-dealer would be required to provide the national best bid or offer, as applicable, to a customer with whom it has a relationship and from whom it has received an order if the customer opted out.

[76] The Commission proposes to define national best bid and national best offer to mean, with respect to quotations for an NMS Security, the best bid and best offer for such security that are calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan; provided, that in the event two or more market centers transmit to the plan processor pursuant to such plan identical bids or offers for an NMS Security, the best bid or best offer (as the case may be) shall be determined by ranking all such identical bids or offers (as the case may be) first by size (giving the highest ranking to the bid or offer associated with the largest size), then by time (giving the highest ranking to the bid or offer received first in time).

transaction that is provided to the customer pursuant to the requirements of Rule 10b-10 under the Exchange Act.[77] The required disclosure could be made on the confirmation for the transaction sent to the customer pursuant to Rule 10b-10 under the Exchange Act, or the monthly account statement relating to that trade sent to the customer pursuant to applicable SRO rules. Alternatively, the broker-dealer could provide the bid or offer information on another form of disclosure document, as long as it is clear to which transaction the bid or offer information refers (i.e., the bid or offer must be displayed in close proximity to, and no less prominently than, the execution price for the relevant transaction).

The Commission intends this requirement to help ensure that customers who opt out of the proposed rule's protections are informed of the consequences of opting out, and are able to compare the execution they received to the best-displayed bid or offer at the time of execution. This disclosure would provide the customer with valuable execution quality information upon which to base future determinations as to whether to opt out of the proposed rule's protections.

The Commission requests comment on the extent to which this information would be useful to investors. The Commission also seeks comment on whether this requirement should apply when the "customer" is another broker-dealer. The Commission further requests comment on whether there would be any practical difficulties in implementing this requirement. In particular, the Commission requests comment as to how this requirement would, or should, apply to transactions that are reported to the customer on an average price basis. Further, the Commission seeks specific comment as to the monetary costs of system or other modifications necessary to provide this information to customers who choose to opt out.

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[77] 17 CFR 240.10b-10. For example, this means that the bid or offer should not be disclosed on a separate page from the execution price for the transaction, and should not be displayed in a smaller font size or type than the execution price.

2. Automated Order Execution Facility Exception

The Commission is proposing to permit an automated market to execute orders within its market without regard to a better price displayed on a non-automated market, within certain price parameters. This exception is designed to reflect the comparative difficulty of accessing market quotes from non-automated markets, and to adjust the trade-through requirement to these differences. The Commission believes this would enhance the ability of individual markets with different market structures to compete more fairly with each other. The Commission is not attempting to favor either form of market.

a. Definition of "automated order execution facility"

This proposed exception contemplates two categories of order execution facilities - an "automated order execution facility" and a "non-automated order execution facility." The Commission proposes to define an "automated order execution facility" as a order execution facility that provides for an immediate automated response to all incoming orders for up to the full size of its best bid and offer disseminated pursuant to an effective national market system plan, without any restrictions on executions. A restriction would include, for example, a limit on the number of orders for the account of the same individual or beneficial owner that could be sent to the market for execution within a certain time frame, or a limit on the size for which an automated response is available, other than the full size of the best bid or offer displayed by the market. The Commission has proposed to narrowly define "automated order execution facility" to exclude market centers that turn off their automatic execution systems or otherwise limit the ability to access their quotes or orders on an automated basis (other than in accordance with federal securities laws, rules, and regulations), to ensure that market participants can readily

access these prices. A "non-automated order execution facility" would include any order execution facility not qualified as an automated order execution facility.

The Commission requests comment generally on these definitions and categories, and specifically whether there are any restrictions that a market center should be allowed to impose and still be considered "automated" under the proposed definition of automated order execution facility. For example, should a market still be considered "automated" under the proposed definition if it were to provide an exception to the operation of its automated functionality when an order would otherwise be executed at a price that would cause a trade-through? How should an order execution facility's response to incoming orders with special handling instructions be treated for purposes of whether an order execution facility would be considered automated, i.e. are there any types of orders with special handling instructions or conditions that an order execution facility should be allowed to exclude from the operation of its automated functionality and still be considered "automated" for purposes of the proposed trade-through rule? For instance, should a market still be considered "automated" even if its automatic execution functionality does not accept orders to sell short? The Commission also requests comment on how such an automated market exception would work in practice for a market that provides an automated response to its top-of-book but otherwise operates as a manual market. Should the definition of "automated order execution facility" exclude a market that has the ability to, and does, implicitly or explicitly "turn off" its automated functionality to allow for manual executions of orders on the market?

The Commission requests comment on whether the Commission, a third party, or each individual market center should determine which market centers qualify as automated order execution facilities, and how such determination should be communicated to the order execution

facilities who must comply with the proposed rule. Further, the Commission requests comment on whether it should specify what "immediate" means in terms of providing an automated response, and if so, whether it would be appropriate to impose a minimum performance standard with respect to response times. Specifically, the Commission requests comment on whether it should require that an order execution facility's system that provides automated functionality have the capability to respond to an order from another market participant within a certain limited time period. If commenters believe that the Commission should specify a performance standard for "immediate," what should that standard be? Should the performance standard require that a certain percentage of all incoming orders receive an execution within a very short time frame, and allow a longer time period for the remaining percentage? For instance, should the performance standard require that 98% of orders receive execution in less than one second, and all orders receive an execution in three seconds? Or should the performance standard require that all orders receive an execution within the same time frame? If so, should that time frame be within one or two seconds after order receipt? Or should another similar standard be used? The Commission also solicits comment on the anticipated competitive effects of the proposed exception on automated and non-automated order execution facilities.

b. Operation of the Exception

An automated order execution facility would be able to trade through the price of a non-automated order execution facility up to the "trade-through limit amount" (as defined below). An automated order execution facility would not be allowed to trade through the prices of other automated order execution facilities. A non-automated order execution facility would not be allowed to trade through any other market, whether or not it is automated. Given the structure of non-automated markets, in particular the time it takes to manually execute an order (which is

necessarily greater because of market maker and crowd participation), the Commission does not believe that there is a particular need to provide a non-automated market an exception to the proposed trade-through rule on the basis of execution speed. The Commission requests comment on the proposed operation of this exception. The Commission also requests comment as to the continued need for the proposed automated market exception if it were to adopt an automatic execution requirement.[78]

c. Allowable Trade-Through Amount

The Commission believes that the amount by which an automated order execution facility should be allowed to trade through a non-automated order execution facility should relate, to the greatest extent possible, to the value of the option that must be given to the other market when attempting to access a better price. Where price protection is the goal, order execution facilities (and their subscribers, customers or members) generally should not be compelled to access another market unless the apparent price improvement from doing so successfully is greater than the estimated cost of attempting access. In short, the allowable trade-through amount should reflect the cost (including time value) of attempting to access the other market.

The calculation of option value is based on several variables, including the volatility and price of the security. Higher volatility means more potential price movement and greater option value, while lower volatility means less potential price movement and less option value. Assuming volatility and other variables as constant, the value of an at-the-money option is proportional to stock price. In granting the three-cent de minimis exemption from the trade-through provisions of the ITS Plan for QQQs, SPDRs and Diamonds, the Commission estimated the option values of attempting to access a better price through ITS to be between one and two

[78] See Section III.D.1. above for a more detailed discussion of this issue.

and a half cents per share.[79] This calculation took into account price and volatility and the fact that ITS commitments are irrevocable for a minimum of thirty seconds. The Commission does not believe, however, that it would be practical to calculate the estimated option value for each NMS Stock that would be subject to the proposed trade-through rule based upon the individual volatility and price of each security. The Commission therefore proposes to calculate the allowable "trade-through limit amount" by using the values of a thirty second option on stocks with a range of volatilities, and estimates such options to have values of approximately five to ten basis points.[80] Specifically, the Commission proposes the following "trade-through limit amounts": for a bid or offer up to $10, the allowable amount would be one cent; for a bid or offer between $10.01 to $30, the allowable amount would be two cents; for a bid or offer between $30.01 and $50 the allowable amount would be three cents; for a bid or offer between $50.01 and $100, the allowable amount would be four cents; and for a bid or offer above $100, the allowable amount would be five cents.

The Commission requests comment on the feasibility and usefulness of this approach, and the reasonableness of the proposed trade-through limit amounts. The Commission also requests comment on other possible alternative approaches to determining the amount(s) by which an automated market should be allowed to trade through a non-automated market. The Commission further requests comment on whether the proposed rule should provide for one trade-through limit amount, such as three cents, that would apply to all NMS Stocks, rather than tiered amounts as proposed.

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79 Given that the price of the QQQs at the time was around $30 per share, three cents represented approximately ten basis points. See Securities Exchange Act Release No. 46428 (August 28, 2002), supra note 48.

80 The Commission has chosen 30 seconds because it is the shortest amount of time for which a market sending an ITS commitment to another market can be irrevocable.

3. Other Exceptions

Section (b)(7) of the proposed trade-through rule would provide an exception in those instances where an order execution facility sends an order to execute against a better-priced order displayed on another market at the same time or prior to executing an order in its own market at an inferior price.[81] Specifically, the exception is intended to apply when the market that wants to execute the inferior priced order (Market A) sends an order, at the same time or prior to executing the trade-through, to execute against any better-priced bid or offer of another market (Market B) that is disseminated pursuant to an effective national market system plan, where such order is priced equal to or better than the price of Market B's better-priced bid or offer and is for the number of shares displayed for that better-priced bid or offer.[82] If the better-priced bid or offer is still available when Market A's incoming order reaches Market B, the incoming order should execute against the better-priced bid or offer. This exception therefore continues to provide protection to the better-priced bid or offer. The Commission emphasizes, however, that if the order sent by Market A to Market B is executed against Market B's better-priced bid or offer, the broker-dealer executing the inferior-priced order, or the broker-dealer on whose behalf the order is being executed, still must fulfill its duty of best execution to its customer with regard

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81 The Commission notes that several SROs have submitted proposed rule changes to the Commission to amend their trade-through rules to include an almost identical exception. See File Nos. SR-NYSE-2003-36, SR-CHX-2003-37, and SR-Amex-2004-07.

82 The Commission notes that this exception is intended to allow for the execution of an order at a price that trades through a better-priced bid or offer displayed on another order execution facility if the order execution facility executing the order has sent an order to trade with that better-priced bid or offer in compliance with the requirements of the exception only during the time period after the market trading through has sent the order to the away market, but before it receives a response or the quote on the away market is updated. It is not intended to allow an order execution facility to execute orders as trade-throughs in reliance on this proposed exception after it has received a response to its order from the away market or the away market has changed its quote.

to that order, by providing the customer order the better price. Thus, this exception would not alter a broker-dealer's duty to provide best execution for its customers' orders.

The proposed rule also would incorporate other exceptions to the current trade-through prohibitions. Specifically, the proposed rule would include exceptions under the following circumstances: (1) the order execution facility displaying the better price was experiencing a failure, material delay or malfunction of its systems or equipment when the trade-through occurred;[83] (2) the order execution facility that initiated the trade-through made every reasonable effort to avoid the trade-through but was unable to do so because of a systems or equipment failure, material delay or malfunction in its own market; (3) the transaction that constituted the trade-through was not a "regular way" contract;[84] (4) the bid or offer that is traded-through was displayed by an order execution facility that was, or whose members were, relieved of their obligations under paragraph (c)(2) of Rule 11Ac1-1 under the Exchange Act (proposed to be designated as paragraph (b)(2) of Rule 602) with respect to such bid or offer pursuant to paragraph (b)(3) of Rule 11Ac1-1 under the Exchange Act (proposed to be designated as paragraph (a)(3) of Rule 602);[85] (5) the transaction that constituted the trade-through was an

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83 The Commission believes that it is appropriate to provide an exception in those instances where a market displaying a better-priced bid or offer was experiencing a failure, material delay or malfunction of its systems or equipment because of the uncertainty as to whether another market would be able to access the better-priced bid or offer in a timely manner or receive a response, or whether its displayed quotes were valid.

84 Providing an exception for a transaction that was executed other than pursuant to standardized terms (not a "regular way" contract) is appropriate because the order likely was executed taking into account factors not related to the current market price, such as extended settlement terms or at a negotiated price away from the market.

85 The Commission believes that this exception is appropriate because an order execution facility should not be required to attempt to match or access a better-priced bid or offer displayed on another market when that bid or offer is not firm under the Commission's Quote Rule, Rule 11Ac1-1 under the Exchange Act (proposed to be designated as Rule 602).

opening or reopening transaction by the order execution facility; and (6) the transaction that constituted the trade-through was executed at a time when there was a crossed market.[86]

The Commission believes the proposed exception for opening and re-opening transactions is appropriate because the process for executing orders at the open, and after a trading halt, involves the queuing and ultimate execution of multiple orders at a single price or several prices, making it difficult to apply the restrictions of the proposed trade-through rule to each individual order to be executed. For example, it would be very difficult for a market center that is attempting to open a security to determine which of the multiple orders it has to execute at the open would receive a better price displayed on another market. It also could be problematic for the market center opening the stock to be able to match the better price, or access the other market to obtain the better price, when that away market price may change during the time period when the market center opening the stock is making its determination as to what price at which to open the stock, and thus not be the current market displayed when the market actually determines the price at which it will open? The Commission recognizes that the opening process in the OTC market for Nasdaq stocks is different than for the listed market, and that the application of the restrictions of the proposed trade-through rule at the opening may make sense in a market that does not have a single-price opening. The Commission requests comment as to

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[86] A crossed market occurs when the best bid is higher than the best offer. The Commission believes this exception is appropriate because any transaction executed in a crossed market would constitute a trade-through under the proposed rule. Therefore, unless the proposed rule contains an exception for a crossed market, no order execution facility could execute in a crossed market without violating the trade-through rule. Such an exception may provide some incentive to market participants not to intentionally cross a market (since their bid or offer that has crossed the market could be executed against), as well as provide an opportunity for the order being executed to be executed at the better, crossed price. Nevertheless, the Commission believes that intentionally crossing the market to take advantage of this exception to the trade-through rule would violate the access rules proposed today. See Section IV, infra.

when, if at all, the execution of orders at the opening and re-opening after a trading halt should be subject to the proposed trade-through rule.

The Commission also requests comment on the appropriateness of the proposed exception for where the order execution facility that initiated the trade-through made every reasonable effort to avoid the trade-through but was unable to do so because of a systems or equipment failure, material delay or malfunction in its own market. What are the types of situations in which this proposed exception would appropriately apply? In other words, when would it be reasonable to allow a market that is not able to execute orders in compliance with the trade-through requirements because of systems problems to continue to execute orders without complying with the proposed rule?

The Commission also requests comment on whether it should continue to include an exception for when a market participant executes a trade-through at a time when the market participant executing the order, and other market participants in its market, were relieved of their firm quote obligations pursuant to the "unusual market" exception of the Quote Rule, provided that unless another exception applies, the market participant executing the order made every reasonable effort to avoid trading through the best bid or offer of any other market participant not so relieved of its firm quote obligations under the Quote Rule.[87]

Although included in the current ITS trade-through rule, the Commission proposes not to include an exception from the trade-through prohibition in cases where the bid or offer that is traded through has caused a locked market.[88] If an exception were allowed for a better-priced locking bid or offer on another market, the order that is being executed would miss the

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87 See, e.g., NYSE Rule 15A(b)(3)(D).

88 See, e.g., NYSE Rule 15A(b)(3)(F) and NASD Rule 5262(a)(5). A locked market occurs when the bid price equals the offer price.

opportunity to be executed at the better price. Also, requiring a market to attempt to access a better-priced locking bid or offer may help to unlock the market more quickly than if the market could trade through the locking bid or offer. The Commission also notes that the proposed access standards discussed in Section IV below would include provisions to deter market participants from locking or crossing the market, and thereby lead to fewer instances of locked markets. Nevertheless, the Commission requests comment on whether it should include an exception for locked markets to the proposed trade-through rule. The Commission also requests comment on whether it should include an exception for locked markets in the trade-through rule if the proposed access rule were adopted without the proposed provision that would require every SRO to establish and enforce rules requiring its members to avoid locking or crossing the quotations of quoting market centers and quoting market participants?[89]

The Commission also notes that the proposed rule, unlike the current rule, does not include an exception for trading through a 100-share bid or offer. The Commission is concerned that a de minimis exception, such as the 100-share exception, would provide an opportunity for market participants to circumvent the requirements of the proposed rule.[90] Nevertheless, the Commission requests comment on whether it is necessary to include an exception for a de minimis size, such as for 100 shares. Finally, the Commission requests comment on whether

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89 See Section IV.B.4. infra for a discussion of locked and crossed markets in the Commission's market access proposal.

90 For example, a market (Market A) that wanted to execute an order at a price inferior to a better price showing on another market (Market B) could send a 100 share order at a better price to Market B, thus establishing a new best bid or offer for Market B. Market A could then trade through the 100 share order, subject to the existing exception for 100 share orders, as well as any other orders below that 100 share order on Market B because Market A only is required to protect the best bid or best offer in each market.

there should be any other exceptions, or whether any proposed exception should not be included.[91]

E. Interaction with Existing Plans/Rules

As noted above, no intermarket trade-through rules currently exist with regard to the trading of Nasdaq securities. With respect to NYSE and Amex securities, the ITS trade-through rule provides that a member should avoid trading through a better price available in another market, subject to certain exceptions detailed in the SROs' rules. The ITS trade-through rule does not include an opt-out or automated market exception. Therefore, unless the ITS Plan and SROs' rules were amended to incorporate the flexibility of the Commission's proposed rule with regard to the proposed opt-out and automated market exceptions, they would remain more restrictive than the proposed rule with regard to those two exceptions. In addition, the proposed rule would eliminate certain of the existing exceptions to the ITS trade-through rule. If adopted, these more restrictive provisions of the Commission rule would, of course, control.

At this time, the Commission is not proposing to amend the ITS Plan or the SROs' trade-through rules on its own initiative to reflect more permissive terms of any trade-through rule that the Commission may ultimately adopt. The Commission believes that market participants should be able to agree, on a voluntary basis, to provide higher levels of protection to each other's prices. And, if the Commission's trade-through and access proposals were adopted, any participant that no longer wanted to be subject to more restrictive trade-through provisions in the ITS Plan could withdraw from the plan, as long as it could comply with the proposed access

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[91] Section (d) of proposed Rule 611 states that the Commission may exempt from the provisions of Rule 611, either unconditionally or on specified terms and conditions, any order execution facility, national securities exchange, national securities association, or broker or dealer, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protections of investors.

standards discussed in Section IV below. However, if the proposed trade-through rule were adopted as proposed, the ITS participants would be required to amend the ITS Plan and their trade-through rules where they conflict with more restrictive provisions in the Commission's proposed rule.

The Commission requests comment on whether the it should require that the ITS Participants amend the ITS Plan and their trade-through rules to implement the proposed trade-through rule in its entirety, if it were adopted, even where the Commission rule would be more permissive than the existing rules. The Commission also requests comment on whether the Commission should amend the ITS Plan and SRO trade-through rules on its own initiative if the proposed trade-through rule were adopted.

F. General Request for Comments

The Commission seeks comments on the trade-through proposal described in this section III. In addition to the specific requests for comment above, the Commission asks commenters to address whether the proposed rule would further the NMS goals set out in Section 11A of the Exchange Act[92] and, in particular, the goal of assuring "the practicability of brokers executing investors' orders in the best market."

The Commission also requests comment on several alternative regulatory approaches to intermarket price protection as outlined below. One alternative would be to adopt the proposed trade-through rule with the automated market exception but not the opt-out exception. Another choice would be to adopt the proposed rule without the automated market exception and extend the existing three-cent de minimis exemption to all securities covered by the proposed rule, either with or without the proposed opt-out exception.

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[92] 15 U.S.C. 78k-1.

Another alternative would be to maintain the existing ITS trade-through rule and allow the three-cent de minimis exemption for certain ETFs (QQQs, SPDRs and Diamonds) to expire. This approach would not address the fundamental problems identified with the operation of the existing rule, although it likely would provide operational continuity for the ITS Plan participants. A variation on this alternative would be to maintain the existing rule, allow the de minimis exception to expire, and add an opt-out exception to the existing rule. Another option would be to maintain the existing rule and approve on a permanent basis the three-cent de minimis exemption for the QQQs, SPDRs and Diamonds. This alternative would not address the issues with the current operation of the ITS trade-through rule with respect to securities other than the QQQs, SPDRs, and Diamonds, although it would provide operational continuity while still providing relief for those three actively-traded ETFs. Two other choices would be to maintain the existing rule and extend the three-cent de minimis exemption either to: (1) all ETFs subject to the ITS Plan; or (2) all securities subject to the ITS Plan. A variation on this latter approach would be to extend the de minimis exemption to all securities subject to the ITS Plan but impose a cap on the size of quotations that could be traded-through. Each of these approaches that would include an extension of the current de minimis exemption would provide some degree of operational continuity.

Another approach would be to eliminate the existing ITS trade-through rule and rely solely upon the principles of best execution. The Commission invites comment on the need for price protection in NYSE, Amex, and Nasdaq securities in today's market, and whether the NMS goals and objectives could be achieved without a trade-through rule. In light of the advent of penny spreads, more efficient executions, active competition between markets trading like securities and a broker-dealer's duty of best execution, in the absence of a trade-through rule,

would accessible better-priced limit orders remain unexecuted if trades were occurring at inferior prices? Would the occurrence of trade-throughs weaken customer confidence in the fairness or efficiency of the market? What would be the competitive effect of removing the trade-through rule from the markets trading NYSE and Amex securities? If price protection is not required, and better-priced limit orders can be ignored, would limit orders be displayed less often?

The Commission requests specific comment on the costs and benefits, and the viability, of each alternative outlined above.

The Commission also requests comment on the feasibility of the proposed trade-through rule. In light of the active trading and frequent quote changes in the markets, would the trade-through rule as proposed impede the efficient execution of orders and raise opportunity costs? Is access between markets efficient enough today to support a trade-through rule? Would this access be adequate if the Commission's proposed access rule – discussed in Section IV - were adopted? How should the proposed trade-through rule reflect access fees charged by market centers? Would the Commission's proposed access fee cap minimize access fees sufficiently that they need not be addressed in the trade-through rule? If the Commission does not ultimately adopt a $.001 standard for access fees, should there be a trade-through rule exception applicable to quotes with access fees of more than a specific amount? If so, should this amount be $.005, $.003, or $.001, or some other amount?

The Commission requests comment as to whether, and if so, to what extent, the proposed trade-through rule would have the desired effect of preventing trade-throughs. Commenters are also asked to comment on the proposed exceptions to the general rule, and whether these exceptions would permit adequate protection of customer orders or, alternatively, undermine the intended effect of the proposed rule. Finally, the Commission requests comment on whether, if it

were to adopt the proposed trade-through rule, a phase-in period would be necessary or appropriate to allow market participants time to adapt to its provisions. If so, what aspect(s) of the proposed trade-through rule should be phased-in, and what would be the appropriate phase-in period?

G. Paperwork Reduction Act

Certain provisions of the proposed rule contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995,[93] and the Commission has submitted them to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 C.F.R. 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information, unless it displays a currently valid OMB control number. The Commission is proposing to create a new information collection entitled "Trade-Through Rule" which would be Rule 611 of proposed NMS under the Exchange Act. OMB has not yet assigned a control number to the new collection of information imposed by proposed Rule 611 under the Exchange Act.

1. Summary of Collection of Information

a. Establishment of Policies and Procedures

The proposed trade-through rule would require an order execution facility, national securities exchange, and national securities association to establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of a trade-through in its market. The nature and extent of the policies and procedures that an order execution facility, national securities exchange, and national securities association would be required to establish to

[93] 44 U.S.C. 3501 et seq.

comply with this requirement would depend upon the type, size, and nature of the order execution facility, national securities exchange, and national securities association.

b. Disclosure Necessary to Obtain Informed Consent for Opt-Out Exception

The proposed rule includes an exception that would permit investors to give informed consent to the broker-dealer to whom they route their order(s) to "opt-out" of the protection provided by the proposed rule on an order-by-order basis. If a broker-dealer chooses to provide investors the ability to opt-out, a broker-dealer would need to, consistent with any fiduciary obligations arising from its relationship with the investor, provide to an investor sufficient disclosure regarding the impact of opting out prior to the investor making a determination whether or not to opt out so that the investor can make a fully informed decision.

c. Disclosure of National Best Bid or Offer in the Event of a Customer Opt-Out

If a broker-dealer chooses to provide customers the ability to opt-out, and in the event a customer chooses to opt-out for a particular order, the broker-dealer to whom the customer routed the order would be required within one month of the date of execution of the order to disclose to the customer the national best bid or offer in the security, as applicable, at the time of execution of the order. The broker-dealer could choose how it would provide such disclosure as long as such disclosure complies with the proposed rule's requirements. For instance, the broker-dealer could include such disclosure on the confirmation sent to the customer pursuant to Section 240.10b-10,[94] on the account statement for the account sent to the customer pursuant to applicable SRO rules, or it could provide the national best bid or offer information in another form of disclosure that is in compliance with the proposed requirements.

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[94] 17 CFR 240.10b-10.

The Commission does not believe that any other market participants would be subject to a requirement under the proposed rule to collect information in addition to what they are already required to collect under existing rules.

2. Proposed Use of Information

a. Establishment of Policies and Procedures

The proposed requirement for each order execution facility, national securities exchange, and national securities association to establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of a trade-through in its market would help ensure that the order execution facility, national securities exchange, or national securities association and its customers, subscribers, members, and employees, as applicable, generally avoid trade-throughs, as contemplated by the proposed rule's requirements.

b. Disclosure Necessary to Obtain Informed Consent for Opt-Out Exception

The need for a broker-dealer to provide an investor sufficient disclosure regarding the impact of choosing to opt out of the proposed rule's protections prior to the investor making an informed determination whether or not to opt out would be necessary to help ensure that each investor, especially a retail customer, makes a fully-informed decision whether to forego the protections afforded by the proposed trade-through rule. The Commission notes that this requirement would only apply to broker-dealers who choose to provide investors the ability to opt-out.

c. Disclosure of National Best Bid or Offer in the Event of a Customer Opt-Out

The proposed rule's requirement that a broker-dealer provide a customer that has opted out of the proposed rule's protection with respect to the execution of a particular order with the

national best bid or offer for that security displayed at the time of the execution of the order, would help ensure that customers are informed of the consequences of opting out by enabling customers to compare the execution price they receive with the national best bid or offer for the security displayed at the time of the execution. The Commission believes that such information would be useful for customers in making future decisions as to whether to opt out of the rule's protections. The Commission notes that this requirement would only apply to broker-dealers who choose to provide investors the ability to opt-out, and whose customers do in fact opt-out.

3. Respondents

a. Establishment of Policies and Procedures

The proposed requirement for each order execution facility, national securities exchange, and national securities association to establish policies and procedures reasonably designed to prevent the execution of a trade-through in its market potentially would apply to the nine registered national securities exchanges and the NASD, and the approximately 6,768 broker-dealers registered with the Commission as of December 31, 2002, which include broker-dealers operating as equity ATSs, broker-dealers registered as market makers in NMS stocks, and any other broker-dealer that has the ability to execute orders within its systems.[95] The Commission requests comment on the accuracy of this estimated figure.

b. Disclosure Necessary to Obtain Informed Consent for Opt-Out Exception

Each of the approximately 6,768 broker-dealers that were registered with the Commission as of December 31, 2002 could potentially choose to provide investors the ability to opt-out. If a broker-dealer were to choose to provide this ability to investors, the broker-dealer

[95] The Commission recognizes that this number may be over-inclusive because it may include registered broker-dealers that do not execute orders and broker-dealers that may not effect transactions in equity securities.

would need to obtain informed consent on an order-by-order basis from an investor in order to allow the investor to opt-out. Thus, each of these entities would need to provide adequate disclosure to an investor prior to the investor making a determination whether to opt out of the proposed rule's protections. The Commission assumes that not all broker-dealers would choose to provide this choice to investors. The Commission specifically requests comment as to how many broker-dealers would choose to allow their customers to opt-out.

c. Disclosure of National Best Bid or Offer in the Event of a Customer Opt-Out

The requirement for a broker-dealer to disclose the national best bid or offer to a customer who chooses to opt out of the proposed trade-through rule's protections potentially would apply to any of the approximately 6,768 broker-dealers that were registered with the Commission as of December 31, 2002 that receive order flow from customers, if they chose to provide their customers the ability to opt-out.[96] This number includes clearing broker-dealers even if they do not have the relationship with the customer, as non-clearing broker-dealers may rely on the clearing firms that carry their customer accounts to send confirmations, account statements, or other disclosure documents related to transactions to their customers. The Commission requests comment on this estimate as to how many broker-dealers would be subject to this requirement, if they chose to offer customers the ability to opt-out.

The Commission has considered each of these respondents for the purposes of calculating the reporting burden under the proposed trade-through rule.

4. Total Annual Reporting and Recordkeeping Burden

a. Establishment of Policies and Procedures

[96] This figure likely includes broker-dealers that do business only with other broker-dealers and would not be subject to this requirement.

Although the exact nature and extent of the required policies and procedures that an order execution facility, national securities exchange, and national securities association would be required to establish would vary depending upon the nature of the order execution facility (e.g., SRO vs. non-SRO, large broker-dealer vs. small broker), the Commission broadly estimates that it would take an SRO approximately 250 hours of legal,[97] compliance,[98] information technology[99] and business operations personnel[100] time,[101] and a non-SRO order execution

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97 The Commission estimates that the average hourly rate for legal service in the securities industry is between $150 per hour and $300 per hour. For purposes of this Release, the Commission will use a rate of $300 per hour to determine potential legal costs associated with the proposed rule.

98 The Commission estimates that the average hourly rate for a compliance manager in the securities industry is approximately $83 per hour. See Securities Industry Association, Report on Management & Professional Earnings in the Securities Industry 2002 (Sept. 2002). For purposes of this trade-through proposal, the Commission applied a 35% upward adjustment for overhead, reflecting the cost of supervision, space, and administrative support for average hourly rate of approximately $110 per hour for compliance personnel time.

99 The Commission estimates that the average hourly rate for a senior computer programmer in the securities industry is approximately $49 per hour. See Securities Industry Association, Report on Management & Professional Earnings in the Securities Industry 2002 (Sept. 2002). For purposes of this trade-through proposal, the Commission applied a 35% upward adjustment for overhead, reflecting the cost of supervision, space, and administrative support for average hourly rate of approximately $65 per hour for information technology personnel time.

100 The Commission estimates that the average hourly rate for an operations manager in the securities industry is approximately $51 per hour. See Securities Industry Association, Report on Management & Professional Earnings in the Securities Industry 2002 (Sept. 2002). For purposes of this trade-through proposal, the Commission applied a 35% upward adjustment for overhead, reflecting the cost of supervision, space, and administrative support for average hourly rate of approximately $70 per hour for business operations personnel time.

101 The Commission anticipates that of 250 hours it estimates would be spent to establish policies and procedures, 115 hours would be spent by legal personnel, 100 hours would be spent by compliance personnel, 15 hours would be spent by information technology personnel and 20 hours would be spent by business operations personnel of the SRO order execution facility.

facility approximately 200 hours of legal, compliance, information technology and business operations personnel time,[102] to develop the required policies and procedures.

Included within this estimate, the Commission staff expects that SRO and non-SRO respondents may incur one-time external costs for out-sourced legal services. While the Commission staff recognizes that the amount of legal outsourcing utilized to help establish policies and procedures may vary widely from entity to entity, the staff estimates that on average, each order execution facility, national securities exchange, and national securities association would outsource 50 hours of legal time in order to establish policies and procedures in accordance with the proposed rule.[103]

The Commission staff estimates that there would be an initial one-time burden of 200 burden hours per SRO or 1,800 hours,[104] and 150 burden hours per non-SRO order execution facility[105] or 1,015,200 hours, for a total of 1,017,000 burden hours to establish policies and procedures designed to prevent the execution of a trade-through for an estimated one-time initial

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102 The Commission anticipates that of 200 hours it estimates would be spent to establish policies and procedures, 85 hours would be spent by legal personnel, 75 hours would be spent by compliance personnel, 20 hours would be spent by information technology personnel and 20 hours would be spent by business operations personnel of the non-SRO order execution facility.

103 The Commission staff does not anticipate that any compliance services would be outsourced.

104 There are eight national securities exchanges (Amex, BSE, CBOE, CHX, NSX, NYSE, Phlx and PCX) and one national securities association (NASD) that trade NMS stocks and thus would be subject to the proposed rule. The ISE does not trade NMS Stocks and thus would not be subject to the proposed rule. The estimated 1,800 burden hours necessary for SRO order execution facilities to establish policies and procedures are calculated by multiplying nine times 200 hours (9 x 200 hours = 1,800 hours).

105 The Commission estimates that there are 6,768 potential non-SRO order execution facilities. The estimated 1,015,200 burden hours necessary for non-SRO order execution facilities to establish policies and procedures are calculated by multiplying 6,768 times 150 hours (6,768 x 150 hours = 1,015,200 hours).

cost of $145,469,475[106] The Commission estimates a capital cost of approximately $101,655,000 for both SROs and non-SROs resulting from outsourced legal work.[107]

Once an order execution facility has established policies and procedures reasonably designed to prevent trade-throughs in its market, the Commission estimates that it would take the average SRO and non-SRO order execution facility approximately two hours per month of internal legal time and three hours of internal compliance time to ensure that its policies and procedures are up-to-date and remain in compliance with the Commission's rule. The Commission staff estimates that these ongoing costs would be 60 hours annually per respondent, for an estimated annual cost of $75,631,320.[108]

The Commission requests specific comments on these estimates, including whether and if so, how many, order execution facilities would choose to accept only opted-out orders, in which case they would not be required to establish policies and procedures. The Commission also requests comment on how costs would differ for the different types of non-SRO respondents.

b. Disclosure Necessary to Obtain Informed Consent for Opt-Out Exception

With regard to the proposed exception that would allow investors to give informed consent to have their orders executed without regard to the protections provided by the proposed

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106 This figure was calculated as follows: (65 legal hours x $300) + (100 compliance hours x $110) + (15 information technology hours x $65) + (20 business operation hours x $70) = $ 32,875 per SRO x 9 SROs = $295,875 total cost for SROs; (35 legal hours x $300) + (75 compliance hours x $110) + (20 information technology hours x $65) + (20 business operation hours x $70) = $ 21,450 per broker-dealer x 6,768 broker-dealers = $145,173,600 total cost for broker-dealers; $295,875 + $145,173,600 = $145,469,475.

107 This figure was calculated as follows: (50 legal hours x $300 x 9 SROs) + (50 legal hours x $300 x 6,768 broker-dealers) = $101,655,000.

108 This figure was calculated as follows: (2 legal hours x 12 months x $300 x (9 + 6,768) + (3 compliance hours x 12 months x $110 x (9 + 6,768)) = $75,631,320.

rule, each broker-dealer receiving order flow from investors that determines to provide investors the ability to opt-out likely would incur one-time start-up costs associated with modifying its internal order handling procedures so as to be able to provide any necessary disclosure to investors. The nature of the needed changes likely would vary for each broker-dealer, depending upon how it receives order flow (e.g. manually over the telephone or through an electronic order routing system). The Commission staff estimates that it would take approximately 140 hours for a broker-dealer to determine the content of the disclosures and how they will be provided, as well as to make any necessary modifications to its order handling systems. This includes approximately 20 hours of legal personnel time, 20 hours of compliance personnel time, 20 hours of business operations personnel time and 80 hours of information technology personnel time. The Commission believes that not all broker-dealers would provide the ability to opt-out, but for purposes of this calculation has included all registered broker-dealers in the cost estimate, which likely over-estimates the cost burden. The Commission requests comment as to how many broker-dealers would offer this ability to investors and how many would not. Further, the Commission staff has assumed for purposes of this burden estimate that all information technology services would be provided internally. The Commission requests comment on the amount of information technology work that a broker-dealer would outsource in order to make modifications to its order handling systems necessary to provide the required disclosure to investors, and how that would impact the costs of making those modifications.

Included within this estimate, the Commission staff expects that broker-dealers may incur one-time external costs for out-sourced legal services. While the Commission staff recognizes that the amount of legal outsourcing utilized to determine the content of the disclosures and how they would be provided may vary widely from entity to entity, the staff estimates that on

average, each broker-dealer would outsource 8 hours of legal time in order to make this determination.[109]

Therefore, the Commission staff estimates that there would be a one-time burden of 893,376 hours[110] for broker-dealers to make changes to their systems necessary to provide disclosure to investors regarding the impact of opting out of the protections offered by the proposed rule for a total one-time cost of approximately $83,923,200,[111] plus a one-time capital cost of approximately $16,243,200 resulting from outsourced legal work.[112]

The Commission staff estimates that costs to comply with this requirement on an ongoing basis would be minimal. Specifically, the Commission staff estimates that it would take one hours of legal time, two hours of compliance time, two hours of business operations time and one hour of information technology time per month to monitor that disclosures are being made appropriately. The Commission staff estimates that these ongoing costs would be 72 hours annually per respondent, for an estimated annual cost of $58,881,600.[113]

The Commission requests specific comments on these estimates.

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109 The Commission staff does not anticipate that any compliance services would be outsourced.

110 The estimated 893,376 burden hours was calculated by adding 12 hours of estimated internal legal personnel time, 20 hours of estimated compliance personnel time, 20 hours of business operations personnel time and 80 hours of estimated internal information technology time and multiplying that by the number of registered broker-dealers, 6,768. ((12 + 20 + 20 + 80) x 6,768 = 893,376)).

111 This figure was calculated as follows: (12 legal hours x $300) + (20 compliance hours x $110) + (20 business operations hours x $70) + (80 information technology hour x $65) x 6,768 = $83,923,200.

112 This figure was calculated as follows: (8 legal hours x $300 x 6,768) = $16,243,200.

113 This figure was calculated as follows: (1 legal hour x 12 months x $300) + (2 compliance hours x 12 months x $110) + (2 business operations hours x 12 months x $70) + (1 information technology hour x 12 months x $65) x 6,768 = $58,881,600.

c. Disclosure of National Best Bid or Offer in the Event of a Customer Opt-Out

If a broker-dealer chooses to provide investors with the ability to opt-out, the proposed rule would require a broker-dealer to provide its customers (but not other broker-dealers from whom it receives order flow) with the national best bid or offer for the security, as applicable, available at the time each customer order was executed, if the customer chooses to opt-out of the protections provided by the proposed rule. These broker-dealers would likely incur one-time start-up costs associated with modifying their procedures and systems to comply with this requirement to provide the national best bid or best offer information to customers for each order for which a customer opts-out of the rule's protections, either on their confirmations, account statements or other disclosure document.

The Commission estimates that it would take approximately 350 hours for a broker-dealer to modify its procedures and systems to be able to provide the national best bid or offer to customers who choose to opt-out for a particular order. This includes approximately 20 hours of internal legal, 20 hours of compliance personnel time, 50 hours of business operations personnel time and approximately 260 hours of internal information technology personnel time. Therefore, the Commission staff estimates that there would be a one-time burden of 2,368,800 hours for broker-dealers to make any changes to their systems necessary to provide customers with the

national best bid or offer in the event a customer opts out of the proposed rule's protections,[114] for an estimated initial one-time total cost of approximately $193,564,800.[115]

The Commission staff has assumed for purposes of this burden estimate that all information technology services would be provided internally. The Commission requests comment on the amount of information technology work that a broker-dealer would outsource in order to make modifications to its systems necessary to provide a customer with the national best bid or offer in the event a customer opts out of the proposed rule's protections, and how that would impact the costs of making those modifications.

Once a broker-dealer's procedures are modified so as to comply with the requirement to provide the national best bid or offer if a customer has opted-out, the Commission believes that the burden of complying with the requirement on an on-going basis should be minimal. The Commission estimates that it would take the average broker-dealer two hours of legal time, five hours of compliance personnel time, five hours of business operations personnel time and five hours of information technology personnel time per month to monitor whether or not its systems are operating correctly so as to provide the required bid and offer information, and to conduct any other necessary systems maintenance. This ongoing cost could be included within the broker-dealer's existing monitoring and surveillance processes. The Commission staff estimates

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114 The estimated 2,368,800 burden hours was calculated by adding 20 hours of estimated internal legal time, 20 hours of estimated compliance time, 50 hours of estimated business operations time and 260 hours of estimated internal information technology time and multiplying that by the number of registered broker-dealers, 6,768. ((20 + 20 + 50 + 260) x 6,768 = 2,368,800)).

115 This figure was calculated as follows: (20 legal hours x $300) + (20 compliance hours x $110) + (50 business operations hours x $70) + (260 information technology hours x $65) x 6,768 = $193, 564,800.

that these ongoing costs would be approximately 204 hours annually per respondent, for an estimated annual cost of $148,219,200.[116]

The Commission specifically requests comment on the frequency with which commenters believe this exception to the proposed rule would be utilized by customers presented with the ability to opt-out of the protections of the proposed trade-through rule, and how this would impact the information collection costs.

5. General Information about Collection of Information

a. Establishment of Policies and Procedures

This collection of information would be mandatory. The Commission expects that the policies and procedures generated pursuant to the proposed rule would be communicated to the members and employees of all entities covered by the proposed rule. Any records generated in connection with the proposed rule's requirement to establish policies and procedures would be required to be preserved in accordance with, and for the periods specified in, Exchange Act Rules 17a-1[117] and 17a-4(e)(7).[118]

b. Disclosure Necessary to Obtain Informed Consent for Opt-Out Exception

To the extent that a broker-dealer determines to provide investors the ability to opt-out, this collection of information would be considered mandatory but the nature and extent of the disclosure to be provided by the broker-dealer necessary to obtain informed consent would vary from investor to investor. To the extent such disclosures are in written form, broker-dealers

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116 This figure was calculated as follows: (2 legal hours x 12 months x $300) + (5 compliance hours x 12 months x $110) + (5 business operations hours x 12 months x $70) + (5 information technology hours x 12 months x $65) x 6,768 = $148,219,200.

117 17 CFR 240.17a-1.

118 17 CFR 240.17a-4(e)(7).

would be required to preserve records of any such disclosures in accordance with, and for the period specified in, Exchange Act Rule 17a-4.[119]

c. Disclosure of National Best Bid or Offer in the Event of a Customer Opt-Out

To the extent that a broker-dealer determines to provide investors the ability to opt-out, and to the extent customers choose to opt-out, this collection of information would be mandatory and would be provided by broker-dealers to customers, and would also be maintained by broker-dealers. Broker-dealers would be required to preserve a record of any disclosure of the national best bid or offer to a customer in the event a customer opts out of the proposed rule's protection in accordance with, and for the period specified in, Exchange Act Rule 17a-4.[120]

6. General Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503,

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[119] 17 CFR 240.17a-4.

[120] 17 CFR 240.17a-4.

and should also send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609, with reference to File No. S7-10-04. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7-10-04, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW, Washington, DC 20549-0609. As OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publications.

H. Consideration of Costs and Benefits

As discussed above, changes in the structure of the equity markets in recent years have called into question the continued viability of the existing system for achieving intermarket price protection. In light of these concerns, the Commission believes that these changes require it to revisit the issue of trading at prices inferior to the best available bids and offers. The Commission therefore is proposing a new rule that would require an order execution facility, national securities exchange, and national securities association to establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of an order in its market at a price that is inferior to a better price displayed on another market.

One exception to the proposed rule would allow an order execution facility to execute an order without regard to the protections of the proposed rule if the person or entity for whose account the order is entered affirmatively makes an informed decision to opt out of the rule's protection. Another exception would provide that order execution facilities that offer immediate automated responses to incoming orders up to the size of their best bid and offer, without

restriction, would be permitted to trade at a price inferior to the best bid or offer of a non-automated market up to limited amount. The proposed rule also would provide for several other exceptions.

As a result of this undertaking, the Commission believes that there will be identifiable cost and benefits. These are discussed below. The Commission requests comment on all aspects of this proposed cost-benefit analysis, including identification of any additional costs or benefits of the proposed rule. The Commission encourages commenters to identify or supply any relevant data concerning the costs or benefits of the proposed rule.

1. Benefits

When an investor receives an execution in one market at a price that is inferior to a better price displayed in another market, that "trade-through" has a cost to the investor receiving the inferior execution. In addition, when trades occur at prices worse than the displayed best bid or offer, it gives an impression of unfairness in the market, particularly to those investors who witness their orders being executed at inferior prices. A trade-through also imposes a cost on the broker-dealer or customer responsible for the best displayed order or quote that is traded through. When trades occur at prices that are inferior to displayed limit orders or quotes, market participants may be less willing to display limit orders or to quote aggressively if they believe it likely that such orders and quotes will be bypassed by executions in other markets at prices that would be advantageous to them. If limit orders frequently remain unexecuted after trades take place at inferior prices, investors may discouraged from entering limit orders, thus reducing price discovery.

By requiring order execution facilities, national securities exchanges, and national securities associations to establish policies and procedures reasonably designed to prevent trade-

throughs, the proposed rule should help ensure that investors consistently receive executions at the best displayed bid or offer (or better), whether through price matching or by orders being routed to markets with better prices, unless an investor chooses to opt-out of the proposed rule's protections or another exception applies. This would be true no matter where the order was being executed (e.g. on an exchange, on SuperMontage, or internally by a broker-dealer). The proposed rule also should facilitate the ability of a broker-dealer to achieve best execution for its customer orders because if a broker-dealer routes an order to a market not showing the best bid or offer, that market should not execute the order at a price that is inferior to the bid or offer displayed on the other market unless an exception applies. These results in turn may help bolster investor confidence in the integrity of the market, which may encourage investors to be more willing to invest in the market, thus adding depth and liquidity to the markets.

The Commission also believes that the proposed rule may encourage the use of limit orders and more competitive quoting because investors who use limit orders, and order execution facilities that quote aggressively, would be more likely to receive an execution because trades would not occur on another market at a price inferior to their orders, except in circumstances where an exception applies. An increase in the use of limit orders and aggressive quoting should likewise enhance price discovery and liquidity in the markets.

Further, because the proposed rule would provide that trades would not execute in one market without regard to the best bids and offers in other markets, the proposed rule should help increase efficiency and encourage competition and order interaction between multiple markets by providing a greater opportunity for orders to interact with one another, particularly on an automated basis. The proposed rule also would permit an automated market to execute orders without regard to a better bid or offer displayed on a non-automated market, within certain price

parameters. This exception is designed to reflect the comparative difficulty of accessing market quotes from non-automated markets, and to adjust the trade-through requirement to these differences. This should enhance the ability of individual markets with different market structures to compete fairly with each other.

In addition, the availability of the proposed opt-out exception, which would provide investors with choice as to whether their orders should trade through a better price, may create market forces that would serve to discipline markets that provided slow executions or inadequate access to their markets. If investors were not satisfied with the level of automation or service provided by a market center, they could choose to opt out of the proposed rule's provisions, thus putting pressure on markets to improve their services. Similarly, because the proposed automated market exception would allow an automated market to trade through better prices displayed on a non-automated market up to a certain amount, an automated market could execute orders in its market without reference to any non-automated market's better-priced orders. Market participants may be less likely to send their order flow to a market center whose orders can be ignored by other markets. To the extent that such a dynamic impacts the ability of a non-automated market to compete and attract order flow, the proposed exception may provide an incentive for a non-automated market to automate, at least for its displayed best bid and offer, which would generally increase the efficiency of the markets and improve the accessibility of better bids and offers for all investors. Markets that would be considered automated pursuant to the proposed automated market exception also may benefit because other markets would not be able to trade through their best displayed bids and offers unless an investor chose to opt out (or another exception applied). Furthermore, the ability of automated markets to trade through non-automated markets may encourage automated markets that do not currently quote in the public

consolidated quote system to do so, which would serve to enhance competition and transparency in the market for NYSE or Amex securities (where the current trade-through rules apply).

The Commission seeks comment on any additional benefits of the proposed trade-through rule, including relevant data to help quantify the expected benefits. The Commission specifically seeks comment on the expected increase in efficiency and decrease in execution costs from allowing investors to opt out and from allowing automated markets to trade-through manual markets up to a certain amount.

2. Costs

Order execution facilities, national securities exchanges, and national securities associations would incur costs associated with establishing, maintaining, and enforcing policies and procedures reasonably designed to prevent trade-throughs. It is difficult to estimate the extent of what these costs would be because the exact nature and extent of the policies and procedures would depend on the type, size and nature of each entity's business.

An order execution facility, national securities exchange, and national securities association would incur costs associated with developing these policies and procedures. As discussed above in Section III.G., the Commission broadly estimates that each SRO that would be subject to this requirement would incur a one-time initial cost for establishing such policies and procedures of approximately $47,875, and each non-SRO order execution facility that would be subject to this requirement would incur a one-time initial cost for establishing policies and procedures of approximately $36,450. Once it has established policies and procedures, each order execution facility, national securities exchange, and national securities association also would likely incur costs associated with maintaining and updating its policies and procedures to ensure they continue to be reasonably designed to prevent trade-throughs. The Commission

broadly estimates that the annual costs for updating the policies and procedures would be approximately $11,160 per order execution facility, national securities exchange, or national securities association. The Commission requests comment on these estimates.

An order execution facility, national securities exchange, and national securities association also would incur initial one-time costs associated with taking action necessary to effectuate the policies and procedures it has developed. For example, an order execution facility, national securities exchange, and national securities association would have to ensure that its members (if applicable) and its personnel responsible for trading in its market are on notice that the order execution facility, national securities exchange, or national securities association is subject to the restrictions of the proposed trade-through rule and that the members and personnel are subject to the order execution facility's, national securities exchange's or national securities association's policies and procedures established pursuant to the proposed rule.[121] Further, all order execution facilities, national securities exchanges, and national securities associations would have to educate and train their employees as to the scope and impact of, and how to comply with, the proposed rule and the policies and procedures implemented by the order execution facility, national securities exchange or national securities association. Moreover, an order execution facility (whether or not it is an SRO or non-SRO), national securities exchange, and national securities association would have to build into its trading or trade reporting system inhibitors to prevent trading at an inferior price to a published quote. Each order execution

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[121] The Commission notes that any member of an SRO that executes orders would be deemed on order execution facility under the proposed rule and thus subject to the proposed rule's requirements. In addition, any member that is not an order execution facility but who receives order flow from customers or other broker-dealers would potentially be subject to the proposed opt-out requirement to obtain informed consent.

facility, national securities exchange, and national securities association would incur costs associated with modifying its systems and procedures to implement these actions.

In addition, each order execution facility, national securities exchange, and national securities association also must, commensurate with its business, incur ongoing costs associated with monitoring for and enforcing compliance with the proposed rule and its own policies and procedures developed pursuant to the proposed rule. The order execution facility, national securities exchange, and national securities association could include provisions for such monitoring and enforcement within its existing policies and procedures for monitoring and enforcing compliance with the federal securities laws, rules, and regulations.[122] Each SRO order execution facility, national securities exchange, and national securities association also would have to include this proposed rule, and its own trade-through policies and procedures, within the scope of its existing procedures for bringing disciplinary actions against its members for violations of the federal securities laws, rules, and regulations and its own rules. Order execution facilities, national securities exchanges, and national securities associations likely would incur costs associated with updating existing enforcement procedures and, for SROs, with updating disciplinary procedures. For example, order execution facilities may incur costs associated with additional personnel time needed to monitor for and investigate instances of trade-throughs, as well as costs associated with modifications to existing monitoring or surveillance systems. The costs of these monitoring and compliance tools may be greater for markets that trade Nasdaq securities, which are not currently subject to a trade-through rule and may not have any existing infrastructure in place.

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[122] For instance, an order execution facility, national securities exchange, or national securities association should develop real-time monitoring or surveillance procedures and reports that would record any instance where an order is executed on its market at a price that trades through a better price displayed on another market.

If a broker-dealer were to choose to provide investors the ability to opt out of the protections of the proposed rule, it would need to, consistent with any fiduciary obligations arising from its relationship with the investor, provide sufficient disclosure to each investor prior to that investor making a determination whether or not to opt out with respect to that order so that the investor can make an informed decision. The Commission preliminarily believes that not all broker-dealers would offer investors the ability to opt out, but has preliminarily included all registered broker-dealers in its cost analysis. Therefore, the Commission estimates that each broker-dealer would incur an initial one-time cost of approximately $14,800 to modify it's order handling procedures and systems to be able to comply with this requirement, and approximately $8,700 annually per broker-dealer to monitor for and maintain compliance with this requirement. The Commission requests specific comment on how many broker-dealers would choose to offer investors the ability to opt out.

A broker-dealer that provided investors the ability to opt out also likely would need to modify its order handling procedures to record for each order whether or not an investor has chosen to opt out of the proposed rule's protections for purposes of order handling. In addition, each order execution facility that executes orders likely would need to modify its order handling and execution procedures to identify incoming orders that are opted-out, for purposes of determining how to execute them, unless the order execution facility chooses to accept only opted-out orders. Broker-dealers and order execution facilities would incur costs associated with making these changes. Furthermore, the proposed rule would require that a broker-dealer that provides customers the ability to opt out and whose customer has chosen to opt out must provide that customer with the national best bid or offer, as applicable, at the time of the execution of the customer's order. Again, while the Commission preliminarily believes that not all broker-dealers

would offer investors the ability to opt out, it has preliminarily included all registered broker-dealers in its cost analysis. Therefore, the Commission broadly estimates that each broker-dealer would incur a one-time initial cost of approximately $28,600 to modify its procedures and systems to provide the national best bid and offer information to customers in compliance with the proposed rule, as well as approximately $21,900 annually per broker-dealer to monitor for continued compliance with this proposed requirement. The Commission requests comment on these estimates.

Order execution facilities also may incur costs to modify their order handling and execution procedures and systems to comply with the proposed automated market exception, as they likely would need to modify their systems to recognize the proposed trade-through limit amounts, as well as which order execution facilities are deemed to be non-automated order execution facilities. The Commission asks commenters to quantify, to the extent possible, the dollar costs of making each of these, and any other, order handling, execution system and other changes necessary to comply with the proposed rule.

Another possible cost would be the potential impact of the proposed rule on the time it would take to execute orders subject to the proposed rule, especially in markets not currently subject to trade-through rules. The process of observing the prices on other markets and determining whether it is necessary to route orders to another market or match a better price on another market could result in slower execution times. The Commission requests comment on the extent to which the imposition of the proposed rule may affect execution times and the impact, if any, this would have on the quality and cost of order executions. The Commission also requests comment on the extent to which the necessity for a broker-dealer to provide disclosure to an investor prior to obtaining informed consent to opt out would impact the speed

with which the order would be executed. The ability to execute orders pursuant to the proposed opt-out and automated market exceptions also may impact the execution price of such orders, in that orders executed pursuant to those exceptions would forego the opportunity to be executed at a better price displayed on another market. The Commission requests comment as to the best way to quantify this potential cost.

The proposed rule also may adversely impact the ability of order execution facilities that would not qualify as "automated" under the proposed rule to compete with other market centers and attract order flow because in certain circumstances automated order execution facilities would be able to execute orders within their markets without reference to better-priced orders displayed in a non-automated market, and investors may be less likely to send order flow to a market center whose order can be bypassed by executions in other markets.

The proposal would apply to broker-dealers that internalize order flow even if they do not post quotes in the consolidated quote. The Commission requests comment on the extent to which the trade-through proposal would impact the profitability of such broker-dealers because they would need to match the price of, or route to, a better priced bid or offer displayed on another order execution facility when executing their customer orders (unless an exception applies).

Finally, the Commission generally requests comment as to whether the operation of the proposed rule would result in the potential costs discussed above, and how to quantify these potential costs. The Commission also seeks comment on any additional anticipated costs of the proposed trade-through rule, including specifics of the dollar amount of such cost impact.

I. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act[123] requires the Commission, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. Section 23(a) of the Exchange Act[124] requires the Commission to consider the anticompetitive effects of any rules that we adopt under the Exchange Act. Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The proposed trade-through rule is intended to be a response to changes that have occurred in the marketplace that have impacted the operation of rules relating to intermarket price protection. The proposed rule would require that an order execution facility, national securities exchange, and national securities association establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of an order in its market at a price that is inferior to the best bid or offer displayed in an order execution facility, unless an exception applies.

The Commission preliminarily believes that the proposed trade-through rule will bolster investor confidence in the markets by helping to ensure that the customer orders are executed at the best price available and providing protection against limit orders being by-passed by inferior priced executions. The price protection provided by the proposed rule should encourage the use of limit orders and aggressive quoting, which should help improve the price discovery process, and in turn, contribute to increased liquidity and depth in the markets. The deeper and more

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[123] 15 U.S.C. 78c(f).

[124] 15 U.S.C. 78w(a).

liquid markets are, the more willing the public may be to invest its capital, thus promoting capital formation.

The Commission also preliminarily believes that the operation of the proposed trade-through rule should help promote efficiency in the markets. In general, a rule that provides price protection across markets should help increase efficiency and reduce the effects of fragmentation because it will help link together competing markets so orders should have a greater opportunity to interact.

Further, by permitting investors to opt out of the proposed rule's protections on an order-by-order basis, the proposed rule would allow investors to have more control over the execution of their orders. By allowing automated order execution facilities to trade through non-automated order execution facilities up to a certain amount, the proposed rule should help promote greater efficiency by enhancing the ability of all markets, regardless of market structure, to operate without undue constraint, consistent with investor protection. By allowing automated order execution facilities to trade through non-automated order execution facilities, the proposed rule also should promote efficiency by facilitating the ability of investor orders to interact more directly on an automated basis.

The proposed rule should promote competition and order interaction among markets by providing that orders would not be able to execute in one market without regard to the best quotes and orders in another market. This should encourage the use of limit orders and aggressive quoting. The proposed rule also should promote competition among markets and provide choice for investors and other market participants by enhancing the ability of different markets with different market structures to efficiently and effectively operate within a single national market system.

The Commission solicits comments on these matters with respect to the proposed rule. Would the proposed rule have an adverse effect on competition that is neither necessary nor appropriate in furtherance of the purposes of the Exchange Act? Would the proposed rule, if adopted, promote efficiency, competition, and capital formation? Commenters are requested to provide empirical data and other factual support for their views if possible.

J. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[125] the Commission must advise OMB as to whether the proposed regulation constitutes a "major" rule. Under SBRFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effect on competition, investment or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. The Commission requests comment on the potential impact of the proposed regulation on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

K. Initial Regulatory Flexibility Analysis

[125] Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996)(codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

The Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA"), in accordance with the provisions of the Regulatory Flexibility Act ("RFA"),[126] regarding the proposed trade-through rule.

The proposed trade-through rule would require any order execution facility,[127] national securities exchange, and national securities association to establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of an order in its market at a price that is inferior to a better bid or offer displayed on another market, otherwise known as a trade-through. The proposed rule would include several exceptions to the trade-through restrictions, including an opt-out option and an exception for automated markets. Specifically, an order execution facility would be permitted to execute an order at a price that trades through a better-displayed price on another market if the person for whose account the order is entered, whether a customer or broker-dealer, affirmatively makes an informed decision to opt out of the rule's protection. In addition, an order execution facility that offers immediate automated responses to incoming orders for up to the full size of its best bid and offer, without any restriction on execution, would be permitted to trade through the price of a non-automated order execution facility up to a specified amount. The proposed trade-through rule also would provide for several other exceptions.

1. Reasons for the Proposed Action

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126 5 U.S.C. 603.

127 The proposed definition of order execution facility in proposed Rule 600 of Regulation NMS includes any exchange market maker; OTC market maker; other broker-dealer that executes an order within its own market or system; alternative trading system; or any national securities exchange or national securities association that operates a facility that executes orders

Over the last twenty years, there have been significant changes in the way the markets operate and compete with each other. There have been technological advances that have resulted in automated quoting and handling of orders and new market participants have emerged with new business models. Some market centers operate entirely electronically, while others continue to conduct floor-based trading. Also, with the advent of trading in decimals, the minimum pricing variation in equity securities has narrowed and there is often less depth at the top-of-book. Issues have been raised as to the continued efficient operation of the current ITS trade-through rule due to these changes in the structure of the markets. This trade-through proposal is intended to address these issues and to respond to the criticisms of the existing rule while still preserving important market integrity and investor protections.

2. Objectives and Legal Basis

The proposed trade-through rule is designed to achieve several objectives. The proposed trade-through rule should help promote the use of limit orders and aggressive quoting by providing a measure of price protection across unlinked, competing markets, while still allowing these markets to operate under their current business models. The proposed trade-through rule also should help facilitate the ability of a broker-dealer to comply with its best execution obligations, and should help to ensure that customer orders receive an execution at the best bid or offer available across multiple markets.

The Commission is proposing the trade-through rule under the authority set forth in Exchange Act Sections 3(b), 5, 6, 11A, 15, 15A, 17(a) and (b), 19, and 23(a).

3. Small Entities Subject to the Rules

The requirement of the proposed trade-through rule that an order execution facility, national securities exchange, and national securities association must establish, maintain, and

enforce policies and procedures reasonably designed to prevent the execution of a trade-through in its market would apply to any market that executes orders in NMS Stocks - specifically, any exchange market maker, OTC market maker, any other broker-dealer that executes orders internally by trading as principal or by crossing orders as agent, any alternative trading system, and any national securities exchange or national securities association. Each of these entities that would qualify as "automated" under the proposed rule also may take advantage of the exception that would allow an automated market to trade through a non-automated market up to a certain amount.

In addition, all broker-dealers who receive orders from customers or other broker-dealers potentially would be subject to the rule's requirements relating to the opt-out exception, regardless of whether or not the broker-dealer executes orders, and thus may not be deemed an order execution facility under the proposed rule. Specifically, if a broker-dealer were to chose to provide investors the ability to opt-out, the broker-dealer would need to provide its customers and broker-dealers from whom it receives order flow with adequate prior disclosure regarding the consequences of opting out of the proposed rule's protections (e.g., potential execution at a price inferior to the best bid or offer) to ensure that the customer or broker-dealer makes an informed decision. If an investor decides to opt out of the trade-through rule's protections, the broker-dealer then likely would need to mark the order as opted-out. The broker-dealer also would be required pursuant to the proposed rule to disclose to a customer that chose to opt-out, within one month of the date the transaction was executed, the best displayed bid or offer for that security available at the time the customer order was executed. Accordingly, the proposed rule would impact a wide variety of market participants. Each is discussed below.

a. National Securities Exchanges and National Securities Associations

None of the existing national securities exchanges is a small entity as defined by Commission rules. Paragraph (e) of Exchange Act Rule 0-10[128] states that the term "small business," when referring to an exchange, means any exchange that has been exempted from the reporting requirements of Exchange Act Rule 11Aa3-1. None of these exchanges is exempt from the requirements. There is one national securities association, which the Commission has determined is not a small entity.

b. Broker-Dealers, Alternative Trading Systems, and Exchange and OTC Market Makers

The proposed rule's requirement to establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of a trade-through, absent an exception, would apply to any order execution facility as outlined above.[129] All of these entities (except the SROs) are registered broker-dealers. The requirements associated with the operation of the proposed opt-out exception to the proposed rule would apply to any broker-dealer that receives order flow from its own customers or other broker-dealers, if the broker-dealer chooses to provide such entities the ability to opt-out. The proposed exception to allow an order execution facility to trade through a non-automated market could be utilized by any order execution facility that qualified as automated under the proposed rule. The other proposed exceptions could apply to any order execution facility subject to the proposed rule's requirements.

Commission rules generally define a broker-dealer as a small entity for purposes of the Exchange Act and the Regulatory Flexibility Act if the broker-dealer had a total capital (net

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128 17 CFR 240.0-10.

129 This means that it would apply to alternative trading systems, registered exchange specialists and market makers, registered OTC market makers, block positioners, and any other broker or dealer that executes orders internally.

worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, and it is not affiliated with any person (other than a natural person) that is not a small entity.[130]

The Commission estimates that as of December 31, 2002, there were approximately 880 Commission-registered broker-dealers that would be considered small entities for purposes of the statute. Each of these broker-dealers potentially would be required to comply with the requirement of the proposed rule to establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of a trade-through in its market. Each of these small entities also would be able to utilize the exception for non-automated markets if it were to qualify as automated under the terms of the proposed rule.

In addition, each of these 880 broker-dealers that are considered small entities could potentially handle orders on behalf of customers or other broker-dealers. If these broker-dealers wanted to offer their customers and broker-dealers from whom they receive order flow the opportunity to opt out, they would be required to obtain informed consent on an order-by-order basis. This would necessitate the broker-dealer providing prior disclosure to investors consistent with any fiduciary obligations arising from its relationship with the investors and recording whether the investor made a decision to opt out. The broker-dealer also would be required to provide the national best bid or offer to a customer who has chosen to opt out.

4. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed trade-through rule would require each order execution facility, national securities exchange, and national securities association to establish, maintain, and enforce policies and procedures reasonably designed to prevent trade-throughs in its market. These

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[130] 17 CFR 240.0-10(c).

policies and procedures must include the ability to monitor for and detect instances of non-compliance with the proposed rule as well as provide for enforcement of the proposed rule.

With regard to the proposed opt-out exception, a broker-dealer that chose to provide investors the ability to opt-out would need to provide adequate disclosure to each investor to ensure that the investor's decision is an informed one, consistent with any fiduciary obligations arising from its relationship with the investor. Broker-dealers would be required to keep a record of any disclosure provided to the investor prior to the investor providing the consent in compliance with Commission or SRO books and records rules.[131] The Commission also anticipates that broker-dealers likely would document a customer's decision to provide informed consent. In addition, for customers that chose to opt out of the proposed rule's protection, broker-dealers would be required to disclose to the customer the national best bid or offer for that security, as applicable, available at the time the customer order was executed.

5. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission has not identified any federal rules that duplicate, overlap, or conflict with the proposed rules.

6. Significant Alternatives

Pursuant to Section 3(a) of the RFA, the Commission must consider the following types of alternatives: (a) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) clarification, consolidation, or simplification of compliance and reporting requirements under the Rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities.

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[131] See, e.g., 17 CFR 240.17a-4.

The Commission does not believe that it is necessary to establish differing compliance or reporting requirements or timetables to take into account the resources available to small entities, nor does the Commission believe that any clarification, consolidation or simplification of compliance and reporting requirements under the proposed rule for small entities is necessary. The Commission notes that the proposed rule was drafted to allow each entity subject to the rule's requirements to develop internal policies and procedures that are appropriate given that entity's type, size and nature. Therefore, the Commission preliminarily believes that the proposed rule already contains flexibility necessary for small entities. Further, the Commission has attempted to draft the proposed rule to be as straightforward as possible to achieve its objective. Any simplification, consolidation or clarification of the rule should occur for all entities, not just small entities. The Commission also does not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed rule as the rule already proposes performance standards and does not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed rule.

Finally, the Commission believes that an exemption from coverage of the proposed rule for small entities would interfere with achieving the primary goals of protecting limit orders and quotes, reducing the effects of fragmentation and helping to ensure customers receive executions at the best bid or offer available. If small entities were not required to comply with the proposed rule, they would be permitted to trade through existing limit orders and quotes on other markets, thus reducing the price protection provided to those displayed limit orders and quotes. In addition, investors whose orders were sent for execution to small entity broker-dealers that were

not required to comply with the rule may not benefit fully from the price protections provided by the proposed rule.

7. Solicitation of Comments

The Commission encourages the submission of comments with respect to any aspect of this IRFA. In particular, the Commission requests comments regarding: (1) the number of small entities that may be affected by the proposed rules; (2) the existence or nature of the potential impact of the proposed rule on small entities discussed in the analysis; and (3) how to quantify the impact of the proposed rules. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rule were adopted, and will be placed in the same public file as comments on the proposed rule.

IV. Market Access Proposal

A. Access to Equity Markets in the NMS

In the market for equity securities today, multiple trading venues seek to attract order flow by competing over liquidity, price, speed of execution, and other significant terms. Currently, however, there are few regulatory standards governing the manner of access among competing market centers.[132] Guided by little more than the fiduciary duty of best execution, a broker must seek the most favorable terms for a customer's transaction reasonably available under the circumstances.[133] And yet if a customer's order cannot be routed to the market with the

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[132] See, e.g., Rule 11Ac1-1 under the Exchange Act; Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) (the "Order Handling Rules Release").

[133] Order Execution Obligations, Securities Exchange Act Release No. 37619A at 50 (September 6, 1996), 61 FR 48290 (September 12, 1996); see also In the Matter of the Application of Robert Bruce Orkin, Securities Exchange Act Release No. 32035 at fn. 22 (March 23, 1993).

best price, a broker may not be able to fulfill the duty of best execution that it owes to its customer. In practice, therefore, the absence of a uniform standard governing the terms of access may have created difficulties for brokers as they seek to obtain the best available prices for their customer orders.

Under Section 11A of the Exchange Act, the Commission is charged with responsibility to facilitate the development of the NMS.[134] The Commission has routinely sought the views of the public as it carries out its responsibilities with respect to the NMS. In 2002, the Commission convened a series of public hearings concerning the structure of the U.S. equity markets. An impressive assembly of investors, investment professionals, academics, and others participated in a series of open hearings on market structure issues, discussing the challenges with respect to market structure and offering widely divergent views as to how the Commission should confront those challenges.

The participants expressed general agreement that the Commission should further the interests of investors by promoting a market structure that encourages the robust interaction of buying and selling interest; that investors, both large and small, are best served by a system that ensures prices are established through fair and vigorous competition among competing market centers; and that investors need to be able to execute transactions in the best market efficiently. These views are fully consistent with general principles that Congress chose in guiding the Commission under Section 11A of the Exchange Act.[135] One important way in which the Commission can further those principles is by providing for fair and effective intermarket access within the NMS.

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[134] See Section 11A of the Exchange Act, 15 U.S.C 78k-1.

[135] See Section 11A(a)(1)(C) of the Exchange Act, 15 U.S.C 78k-1(a)(1)(C).

Ensuring access to diverse marketplaces within a unified national market would foster efficiency, enhance competition, and contribute to the "best execution" of orders for securities.[136] Accordingly, the Commission today is proposing new standards governing access to quotations and the execution of orders for equity securities throughout the NMS. The proposed new access standards, proposed to be designated as Rule 610 of Regulation NMS, would require market centers to permit all market participants access to their limit order books, at least indirectly, on a non-discriminatory basis. In addition, the proposed rule would limit any fees charged by market centers and broker-dealers for access to their quotations to a de minimis amount. Finally, the proposal would require SROs to establish rules to reduce the incidence of inter-market locked and crossed quotations .

1. Current Access Framework

Broker-dealers have a duty to seek the most favorable terms reasonably available in executing transactions on behalf of their customers.[137] The price at which an order can be executed is of paramount importance for most investors, but in seeking the best price some investors may weigh other factors, such as the speed and certainty of execution at a specified price, even more than the possibility of execution at a better price. In today's market for equity securities, multiple marketplaces compete over price, speed, and other terms. To fulfill the duty of best execution, therefore, a broker-dealer must be able to identify the best available terms among multiple competing marketplaces, and gain fair and efficient access to those marketplaces. Any weakness or inefficiencies in the system of reaching quotations and

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136 Id at Section 11A(a)(1)(D), 15 U.S.C 78k-1(a)(1)(D).

137 See, e.g., Charles Hughes & Co. v. SEC, 139 F.2d 434 (2nd Cir. 1943).

executing orders among market centers could compromise a broker-dealer's ability to satisfy its duty of best execution.

Today's NMS features competing pools of liquidity in stocks listed on the NYSE, the Amex, and Nasdaq, though the nature of the competition differs in each of those categories. For NYSE-listed stocks, the NYSE currently dominates trading with approximately 75% of the volume. NYSE stocks are also traded on regional exchanges, and in the OTC market by block positioners and market makers through Nasdaq's intermarket system. To a lesser extent, NYSE stocks are traded on ECNs. The competition is similar for Amex-listed stocks. Although the Amex currently has a significant part of the volume in Amex-listed stocks, ECNs and the Archipelago Exchange, the equities trading facility of the PCX, have the predominant share of the volume of ETFs. In stocks registered on Nasdaq, market makers and some ECNs trade on SuperMontage, Nasdaq's order collection, display, and execution facility. A few ECNs post orders on the ADF, the NASD's quotation display and trade reporting facility. Still other ECNs post their quotes and print trades at the NSX. Finally, the Archipelago Exchange maintains a system for electronically executing trades and routing orders outside of SuperMontage.

With respect to exchange-listed equity securities, members of exchanges and the NASD currently can access each other’s quotes through the ITS. Physical access is provided by ITS connectivity, and the terms of access are governed by the ITS Plan. Participants in the ITS Plan have agreed not to charge for access to their markets through the ITS. The ITS Plan provides grievance procedures for violations of the ITS trade-through rule and sets forth procedures to follow in the event of a locked or crossed market.

The basic terms of intermarket access in Nasdaq securities are set forth in the Nasdaq UTP Plan. Unlike the ITS Plan, the Nasdaq UTP Plan does not establish a physical linkage for

Nasdaq stocks or provide limitations on trade-throughs or locked and crossed markets. Instead, the Nasdaq UTP Plan requires only that each participant in the Nasdaq UTP Plan provide direct telephone access to each market maker or specialist in its market, and forbids participants from imposing access or execution fees with respect to transactions in Nasdaq securities that are communicated by telephone.[138] Currently, the NASD, Amex, NSX, CHX, BSE, and PCX trade Nasdaq securities under the Nasdaq UTP Plan.

The registered national exchanges, market makers, ECNs, and other broker-dealers may access Nasdaq's SuperMontage through a Nasdaq member to reach quotations displayed in SuperMontage, but they need not use SuperMontage in order to trade Nasdaq securities. The NASD operates the ADF as an alternative to SuperMontage. The ADF does not operate a linkage or execution system like SuperMontage; rather, market participants must obtain their own access to ADF participants under the ADF's rules governing access.[139] These rules provide that ADF participants must make electronic access to their quotations available in the ADF.

Under the Commission's Quote Rule,[140] if a market maker enters an order into an ECN that betters its own quote, the market maker generally must reflect that order in its quote unless the ECN has reflected the order in the quote it provides to an exchange, the ADF, or Nasdaq, and the ECN enables brokers-dealers to reach the market maker's order displayed through the ECN as easily as they could reach that order directly through an SRO. In short, the ECN must allow any broker-dealer to effect a transaction against the order on the same terms as if the broker-

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138 See Nasdaq UTP Plan, Section IX (a) and (b).

139 See Securities Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49822 (July 31, 2002) (SR-NASD-2002-97); Securities Exchange Act Release No. 47663 (April 10, 2003), 68 FR 19043 (April 17, 2003) (SR-NASD-2003-67) (extending pilot program).

140 See Rule 11Ac1-1 under the Exchange Act, 17 CFR 240.11Ac1-1.

dealer had carried out the transaction directly with the market maker whose order is represented in the ECN.

The Commission's Regulation ATS has integrated ECNs and ATSs more fully into the NMS.[141] Under Regulation ATS, an ATS with at least five percent of the trading volume in any particular security must publicly display its best-priced orders in that security to an exchange, the ADF, or Nasdaq, and must allow market participants to access those publicly displayed orders.[142] Furthermore, an ATS with 20 percent or more of the trading volume in any particular security must provide "fair access" to its system; that is, it must not unreasonably prohibit or inhibit any person from obtaining access to the services that it offers.[143] Such an ATS may, however, establish fair and objective criteria, such as creditworthiness, to differentiate among potential participants. Currently, six ATSs operate as ECNs, and display quotes through SuperMontage, the ADF, the BSE, or the NSX.

In a system with so many competing market centers and pools of liquidity, market participants not only need to know what the best prices are and in which market they are available, but they also must be able to access that market routinely and efficiently. Historically, however, markets have attempted to maintain effective control over the terms of inbound order access by seeking to erect barriers in the form of fees, execution priorities, membership requirements, direct bans, and other restrictions.[144] The proposed access standards are designed to substantially reduce these barriers to intermarket access.

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141 See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Release").

142 See Rule 301(b)(3) under the Exchange Act, 17 CFR 240.301(b)(3).

143 See Rule 301(b)(5) under the Exchange Act, 17 CFR 240.301(b)(5).

144 See, e.g., Regulation ATS Release, 63 FR 70844.

2. Nonlinked Markets

Historically, the NYSE and the regional exchanges have primarily functioned as agency markets, while the OTC market has primarily functioned as a dealer market. In recent years, these distinctions have blurred. In block trades, which occur both on and off exchanges, major broker-dealers take one side as principal. Moreover, dealers act as OTC market makers in a number of NYSE stocks.[145] By contrast, the market for Nasdaq securities, which has historically been dominated by OTC market makers, has been marked in recent years by an explosive growth in ECNs that function exclusively on an agency basis.

Heightened competition among market centers has led to market fragmentation -- the trading of orders in multiple locations -- and this has reduced interaction among orders dispersed across the competing markets. The intermarket linkage systems currently in place in the NMS provide a means of access to the best displayed prices, but they are not comprehensive and have been criticized for their inefficiencies.

In the OTC market, the development of SuperMontage, the creation of the ADF, and the growth of ECNs have created multiple venues for the trading of Nasdaq stocks. SuperMontage does not route orders away from its system. Instead, market participants rely on private routing systems to trade across markets in order to obtain the best prices for customer and proprietary orders in Nasdaq stocks.

Before the launch of SuperMontage, nearly all of the ECNs participated in Nasdaq. Recently, however, several ECNs have chosen to operate independently of Nasdaq. Following

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145 The rescission of NYSE Rule 390 in 2000 allowed NYSE members to serve as OTC market makers or dealers in all NYSE-listed securities. See Securities Exchange Act Release No. 42450 (February 23, 2000), 65 FR 10570 (February 29, 2000) (notice of proposed rescission); Securities Exchange Act Release No. 42758, 65 FR 30175 (May 10, 2000) (order approving rescission).

SuperMontage's launch in 2002, several ECNs chose to remain outside of SuperMontage and to post their quotes in the ADF. The ADF is a pure display and trade reporting facility that offers neither order executions nor the automatic routing of orders. In accordance with the ADF's rules, ADF participants are linked to each other pursuant to privately negotiated linkage agreements.

With respect to NYSE and Amex securities, the market centers that trade those securities are currently linked through the ITS. The ITS provides the ability to route commitments individually from one market center to another for execution. In recent years critics have charged that the ITS is inefficient, and that the ITS Plan does not easily accommodate new business models.[146] In particular, the provision of the ITS Plan governing trade-throughs and locked and crossed markets requires ITS Participants to wait up to 30 seconds for a response from other markets to avoid trading at a price worse than their published quote. Some ECNs have asserted that the ITS Plan is incompatible with their trading systems, which allow trades to be executed electronically within a fraction of a second.[147] Moreover, because any amendment to the ITS Plan requires the unanimous agreement of the ITS Participants, any single Participant may effectively wield veto authority over any proposed change to the ITS.[148] For this reason,

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146 See, e.g., Beatrice Boehmer, Trading Your Neighbor's ETFs: Competition Or Fragmentation, J. Banking & Finance, September 2003; Ivy Schmerken, Will The NYSE Specialist Probe Open The Listed Markets To ECNs?, Wall Street & Technology, July 1, 2003; J. Alex Tarquino, Electronic Communication Networks Look Toward The Big Board, N.Y. Times, December 29, 2002.

147 See, e.g., Kouwe, Zachery, As The Campaign For ETF Trading Volume Presses On, Island Goes Dark, Arca Gains Market Share, And The Major Exchanges Fight To Hold Their Own, Alternative Investment News, August 1, 2003; Koh, Peter, Nasdaq Faces An Identify Crisis, EuroMoney, July 1, 2003; Sales, Robert, ADF Looks To Bypass ITS For Listed Equities, Wall Street & Technology, December 1, 2002.

148 Intermarket Trading System Plan, Section 4.C; see Securities Exchange Act Release No. 19456 (January 27, 1983), 48 FR 4938 (February 3, 1983). See also Securities Exchange Act Release No. 40260 (July 24, 1998), 63 FR 40748 (July 30, 1998) (proposing amendment to provision requiring unanimous approval of participants).

among others, critics have charged that the ITS Plan has been slow to embrace new technology and, more important, new competition.[149]

One consequence of fragmentation has been a rise in the incidence of locked markets.[150] A locked market occurs, for instance, when an offer to sell at a certain price is displayed on one market at the same price as an offer to buy on another market, but the orders cannot meet because the two markets are not linked. For example, a market that posts an order on SuperMontage to buy a security at $10.01 may have its quote locked when an ECN posts an order on the ADF to sell the security at $10.01. Because the bid and ask quotes are identical and yet they do not execute across markets, some market centers' automatic execution systems may perceive the quotes to be stale or incorrect, and shut down.

There is anecdotal evidence that the incidence of locked markets has gained pace in recent months.[151] As discussed more fully below, some critics have charged that the dramatic increase in the frequency of locked markets can be traced to access fee and liquidity rebate strategies that have created economic incentives for some market participants to lock the market.

Another issue raised by trading across competing market centers is the speed and/or certainty of access among these markets. Trading in penny increments has resulting in narrower spreads, less depth at the top-of-book, and rapid movements between price points. At the same time, advances in technology, including the use of "smart" order-routing and automatic execution systems, have provided a variety of means of routing and executing orders in multiple

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149 See, e.g., Chapman, Peter, National Markets Under Fire, Trader's Magazine, November 1, 2002.

150 See, e.g., Schmerken, Ivy, Nasdaq's Battle Over Locked Crossed Markets, Wall Street & Technology, May 1, 2003.

151 Id.

markets more quickly and efficiently. The speed at which trading occurs in some markets has increased as market participants strive to make greater use of technology to execute orders at the prices they see before the prices change. Therefore, as markets have become more automated, the speed at which markets can access each other has taken on greater importance.

Competing market centers, however, currently offer different types of access and different speeds of execution. For instance, in the market for trading Nasdaq securities, which is highly automated, market participants have objected to the extension of trading pursuant to the Nasdaq UTP Plan to exchanges that do not offer automatic execution.[152] With regard to exchange-listed securities, market participants also have voiced concerns with the operation of existing trade-through rules and the impact of those rules on the efficient operation of automated markets. Various market participants have argued that all competing markets should offer automatic execution.[153]

The Commission has been reluctant to mandate automatic execution, in part because of a concern that doing so might be incompatible with the business models of individual market centers and interfere with the ability of individual market centers to compete.[154] Given the changes that have occurred in the markets in recent years, however, and particularly the widespread use of electronic execution in some markets, the Commission requests comment on

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[152] See, e.g., letter to Jonathan G. Katz, Secretary, Commission, from John J. D. McFerrin-Clancy, Schlam Stone & Dolan, dated August 15, 2002 (petition for review of Securities Exchange Act Release No. 46205 by Knight Trading Group, Inc.).

[153] See, e.g., letter to Jonathan G. Katz, Secretary, Commission, from Mark B. Sutton, Chairman, SIA Market Structure Committee, Securities Industry Association, dated May 5, 2000, commenting on Securities Exchange Act Release No. 42450.

[154] See, e.g., Securities Exchange Act Release Nos. 43084 (July 28, 2000), 65 FR 48406 (August 8, 2000) (proposing Rules 11Ac1-5 and 11Ac1-6 under the Exchange Act), and 46305 (August 2, 2002), 67 FR 51609 (August 8, 2002) (order approving Amex rule proposal relating to the trading of Nasdaq securities).

whether its proposed access standards should require a "quoting market center" or a "quoting market participant," as defined in the rule, to execute orders at its quote automatically. The Commission also requests comment on the scope of any such automatic execution requirement. For example, should each quoting market center and quoting market participant be required to offer automatic execution with respect to its entire trading book? Or should an automatic execution requirement be limited only to the best bids and offers of quoting market centers and quoting market participants?

The concept of automatic execution entails the immediate electronic execution of orders against quotes or orders present in the market. Yet, different automated markets can have significantly different execution speeds depending on their internal processes and the technology employed. Therefore, if the Commission determines to require automatic execution, the Commission requests comment as to whether it should promulgate performance standards to ensure that the quotes of all market participants are available for automatic execution.[155] Such performance standards would be designed to ensure that all automatic execution systems satisfy minimum standards that would assure that market participant orders are executed in substantially equivalent timeframes across markets.

Accordingly, the Commission requests comment as to whether it would be appropriate to impose a minimum performance standard with respect to response times for automatic execution. Specifically, the Commission requests comment on whether it should impose a requirement on market participants, mandating that their automatic execution systems provide the capability to respond to an order from another market participant within certain timeframes. For example, a general standard could be imposed that would require markets to provide automatic executions

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[155] The Commission notes that the ADF currently imposes minimum performance standards for participants in its order quotation and display facility. See NASD Rule 4300A(e).

of all orders within a specified timeframe after receipt (e.g., one or two seconds). A more refined alternative standard could require markets to provide automatic execution of (1) all orders within a longer timeframe after receipt (e.g., three seconds) and (2) a specified percentage of orders (e.g., 98%) within a shorter timeframe after receipt (e.g., one second). The Commission requests comment on the nature of any minimum performance standard, with respect to response times for automatic execution, that should be imposed on market participants.

The Commission also believes that, if quoting market centers and quoting market participants were required to offer automatic execution, it would be critical that the automatic execution functions of quoting market centers and quoting market participants not unfairly discriminate by offering their members faster automatic execution than they offer to non-members. In the Commission's view, such discrimination would be inconsistent with the standard of equivalent access and would thwart the goals of Section 11A of the Exchange Act.

3. Access Fees

ECNs that display their quotes in the public quotation system typically charge per share "access fees" to non-subscriber market participants that trade with the orders that the ECNs display. These fees are generally similar to the fees that subscribers pay to trade with ECN orders.[156] In its rules requiring ECNs and ATSs to display their quotes, the Commission permitted ECNs to charge a fee "similar to the communications and systems charges imposed by various markets, if not structured to discourage access by non-subscriber broker-dealers."[157] ECNs may not charge fees that have the effect of creating barriers to access for non-subscribers,

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156 Regulation ATS Release, 63 FR 70844.

157 Order Handling Rules Release, 61 FR at 48314 n.272; see Regulation ATS Release, 63 FR 70844.

however.[158] Currently, pursuant to a series of no-action letters from the Division of Market Regulation, ECNs charge fees to non-subscribers in amounts equal to those that they charge a "substantial proportion" of their active broker-dealer subscribers, but no more than $.009 per share.[159] The fees that ECNs charge vary in size depending on the ECN.

Although ECNs charge other market participants per-share fees for access to their quotes, other market participants, most notably market makers, must trade at their displayed quotes without imposing access fees.[160] Therefore, depending on the identity of the market participant that has posted a quotation, a displayed price may be the true price that a customer will pay, or it may be the base price to which an access fee is subsequently appended. In addition, the exchanges and Nasdaq typically charge a variety of transaction fees. Accordingly, published quotes today do not reliably indicate the true prices that are actually available to investors.

As ECNs have become more active in the equities markets, the absence of a uniform quoting convention has made it difficult for market participants to compare quotations readily across all marketplaces. Indeed, because the ECNs' displayed quotes do not reflect the per-share access fees that they impose, the NBBO can be viewed as artificially narrow. Market makers and other broker-dealers that owe a duty of best execution to customers nevertheless are held to the benchmark that the NBBO reflects. Accordingly, some market participants believe that,

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158 Id.

159 The no-action letters are posted to the Commission's web site at http://www.sec.gov/divisions/marketreg/mr-noaction.htm#ecns. See also Regulation ATS Release, 63 FR 70844 ("The Commission believes that fees charged by an alternative trading system would be inconsistent with equivalent access if they have the effect of creating barriers to access for non-subscribers").

160 See Rule 11Ac1-1(c)(2) under the Exchange Act, 17 CFR 240.11Ac1-1(c)(2); see also Letter from Robert L.D. Colby, Deputy Director, Division of Market Regulation, Commission, to Louis B. Todd, Jr., Head of Equity Trading, J.C. Bradford & Co., dated August 6, 1998.

under the circumstances, a non-subscriber should not be forced to pay a fee to an ECN in order to obtain the execution of a customer order at the NBBO.

Furthermore, there is a view that the dramatic rise in locked and crossed markets in recent years can be traced to the proliferation of access fees, charges, and liquidity rebates offered by ECNs and Nasdaq.[161] These practices -- paying so-called "liquidity rebates" to customers that post limit orders, while imposing access fees on orders that execute against those resting orders -- arguably have encouraged locked and crossed markets.[162]

Indeed, several of the largest ECNs currently pay $.002 per share to order providers upon the execution of their limit orders, and simultaneously charge $.003 to the "liquidity takers" whose orders execute against resting limit orders in the ECN. If, for example, a market maker posts the best bid on SuperMontage in a particular security at $20.00, a customer could enter a market order to sell that executes against the bid, and sell the stock at the $20.00 bid price (plus a $.003 per-share SuperMontage fee).[163] By submitting a sell limit order to an ECN that is not linked to SuperMontage and that does not have a $20 bid at that time, the customer could lock the market at $20.00 bid, $20.00 asked. Rather than paying an access fee to execute against the displayed order, the customer could simply wait for some other market participant to unlock the

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161 See, e.g., Schmerken, Ivy, Nasdaq's Battle Over Locked Crossed Markets, Wall Street & Technology, May 1, 2003.

162 Id.

163 SuperMontage subscribers pay a fee of $.003 per share, up to a certain per-order maximum limit, to execute against orders in the book. ECNs currently charge non-subscribers that access their markets through SuperMontage an additional access fee of up to $.003 per share or more. The Commission has approved an NASD rule change that, in part, establishes the maximum fees that ECNs may charge when their orders are accessed through SuperMontage. See Securities Exchange Act Release Nos. 48501 (September 17, 2003), 68 FR 56358 (September 30, 2003) (proposal) and 49220 (February 11, 2004) (approval) (SR-NASD-2003-128).

market by executing an order against the customer's quote, and thus receive a liquidity rebate from the ECN in the process. In this scenario, the $.005 per share difference between paying an access fee and receiving a liquidity rebate gives an economic incentive to encourage the repeated locking of markets in some securities.[164]

B. Proposed Access Standards Under Regulation NMS

The Commission today is proposing to adopt new regulations governing intermarket access to quotes and orders in the equity markets of the NMS. The new provisions would be designated as Rule 610 of Regulation NMS.[165]

1. New Terms

For purposes of the new provisions governing access, the Commission proposes to include in a new rule that would be designated as Rule 600 of Regulation NMS two new defined terms to identify the parties to which the access provisions apply.[166] The Commission intends these terms broadly to include all market participants that either are required, or otherwise choose, to display quotations in the NMS. A "quoting market center" would be defined to mean an order execution facility of any exchange or association that is required to make available to a quotation vendor its best bid or best offer in a security pursuant to the Quote Rule.[167] A "quoting market participant" would be defined to mean any broker-dealer that provides its best bid or best offer in a security to an exchange or association pursuant to the Quote Rule or Regulation ATS,

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164 Of course, this problem would be exacerbated if the ECN charges an even higher access fee, such as $.009 per share.

165 In addition, proposed Rule 610(d) would provide the Commission with exemptive authority pursuant to Section 36 of the Exchange Act, 15 U.S.C. 78mm.

166 See the rule proposed to be designated as Rule 600 of Regulation NMS.

167 Rule 11Ac1-1 under the Exchange Act, 17 CFR 240.11Ac1-1. Under proposed Regulation NMS, the Quote Rule is proposed to be redesignated as Rule 604.

and whose best bid or best offer is not otherwise available through a quoting market center. Accordingly, a market center such as an exchange that offers execution functionality would be considered a quoting market center, while a market participant that enters quotations on a quotation facility that does not offer order execution functionality, such as the ADF, would be considered a quoting market participant.

2. Access to Published Bids and Offers

Under the proposed rule, quoting market centers and quoting market participants would not be permitted to impose unfairly discriminatory terms that inhibit non-members, non-subscribers, or non-customers from obtaining access to quotations and the execution of orders through their members, subscribers, or customers. Moreover, a quoting market participant would be required to make its quotations accessible to all quoting market centers and all other quoting market participants on terms as favorable as those it grants to its most preferred member, customer, or subscriber.[168]

The proposed rule seeks to ensure access not through government-imposed linkages, but rather through linkages established by the marketplace. At the core of the proposed new rule is a provision that would prohibit quoting market centers and quoting market participants from imposing unfairly discriminatory terms that prevent or inhibit any person from accessing their quotations indirectly through a member, customer, or subscriber. This standard is intended to ensure that a member, customer, or subscriber of a quoting market center or quoting market participant can sponsor access to quotes and order execution without receiving disparate treatment in the handling of that order with respect to fees, speed, or other terms. Under this

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[168] For example, non-subscribers or non-customers of a quoting market participant would be entitled to the very best level of service, and at the very best rates, that it offers to any of its subscribers or customers.

rule, the quoting market center or quoting market participant would not be permitted to treat orders from non-members, non-customers, or non-subscribers that are communicated indirectly through a member, customer, or subscriber any differently from the way it treats the orders of that member, customer, or subscriber. Consequently, securities market participants would not need to establish direct relationships with every quoting market center or quoting market participant in order to access the quotes of all markets; rather, these participants need only have relationships with a member, customer, or subscriber of a quoting market participant or a member, customer, or subscriber of a quoting market center to obtain effective access to those quotes.

The new rule also would require each quoting market participant to make its quotations available, for the purpose of order execution, to all quoting market centers and all other quoting market participants on terms as favorable as those it grants to its most preferred member, customer, or subscriber. Currently, although ADF participants have established linkages among themselves pursuant to private agreements, a non-ADF participant potentially could have no means by which to access the quotes of an ADF participant, particularly if no ADF participant is willing to offer ready access to non-ADF participants. Therefore, in very limited circumstances, the proposed access rule effectively would impose "direct access" obligations on an ADF participant or other quoting market participant that has not yet established linkages between itself and quoting market centers.

3. Access Fees

i. How Access Fees Cause Distortion in the Markets

Under Regulation ATS, ECNs that display market maker quotes or are responsible for at least 5% of the trading volume in a stock must furnish their quotes to the public quotation

system, where the quotes are displayed along with the quotes of traditional exchanges and market makers. The Order Handling Rules Release stated that an ECN "may impose charges for access to its system, similar to the communications and systems charges imposed by various markets, if not structured to discourage access by non-subscriber broker-dealers."[169]

Although access fees have decreased steadily in recent years, the fees nonetheless are currently causing various distortions in the trading of securities. Most ECNs and Nasdaq pay a per-share rebate for limit orders that become executed against incoming orders. This rebate rewards market participants for submitting "resting" limit orders that give depth to the trading book. The ECNs and Nasdaq also impose a per-share access fee on the incoming marketable orders that execute against the resting limit orders and thereby "remove liquidity" from the book. In this way, the ECNs and Nasdaq effectively use access fee rebates as payment to attract liquidity to their limit order books. Because non-subscribers cannot place limit orders on an ECN's book and therefore cannot receive the rebates, the fees that they pay act as a subsidy to the subscribers that place standing limit orders on the ECN's book. Therefore, the more an ECN can charge in access fees, the more it can rebate to its subscribers. In practice, some ECNs charge considerably more than others. In the current decimal trading environment, where penny spreads are commonplace, these differences can add significant non-transparent costs to securities transactions. This may undermine the "fair access" standards established in the Order Handling Rules and Regulation ATS.

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[169] Order Handling Rules Release, 61 FR at 48314, n.272.

Furthermore, Rule 11Ac1-1(c)(2) under the Exchange Act prohibits non-ECN broker-dealers from charging an access fee in addition to their posted quotation.[170] Although Nasdaq's current pricing and rebate structure indirectly provides limited rebates of Nasdaq's access fees to market participants, many believe that prohibiting non-ECN broker-dealers from charging access fees, but not their ECN competitors, puts the non-ECN broker-dealers at an unwarranted competitive disadvantage.

Finally, many believe that ECN access fees exacerbate locked markets. In addition to the concerns raised in Section IV.A.3. above, some allege that certain ECNs have programmed their systems to lock the quote of other market participants automatically. These critics believe that some ECNs routinely lock quotations instead of routing orders to the other quote, simply so that they can force a contra-party to be a "liquidity taker" and thereby collect the associated access fee rebate for themselves.[171] They assert that these ECNs are able to induce others to execute against the quotation that is locking the market, in order to clear the locked quotation and allow their automatic execution systems to work.[172] In the Commission's view, impediments to access

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170 17 CFR 240.11Ac1-1(c)(2); see letter from Robert L.D. Colby, Deputy Director, Division of Market Regulation, Commission, to Louis B. Todd, Jr., Head of Equity Trading, J.C. Bradford & Co., dated August 6, 1998.

171 See, e.g., Clary, Isabelle, Trading Under New Rules, Securities Industry News, January 12, 2004.

172 Because some market makers' automatic execution systems are programmed not to process trades while a quotation is locking or crossing the market, market makers regularly execute against locking or crossing quotations -- and pay the ECN access fee -- to clear such quotations out of their automatic execution systems. Under NASD Rule 4613, market participants are prohibited from locking or crossing the market in a security within Nasdaq systems, but there is no inter-market rule prohibiting locking and crossing of the market for Nasdaq securities. Therefore, market participants today are permitted to lock or cross the market in the public quotation stream when they are quoting Nasdaq securities on a non-Nasdaq system, such as the ADF.

may lead to locked markets, create difficulty for market participants seeking best execution for customer orders, and call into question the efficiency of the marketplace.

ii. Regulatory Alternatives With Respect To Access Fees

The Commission has considered various regulatory responses to the growing problems that access fees cause. Among these, four alternatives merit discussion here: reflecting the access fees in the displayed quote; rounding access fees to full-penny trading increments in the displayed quote; banning access fees outright; and establishing a de minimis fee standard.

First, the Commission has considered a requirement that access fees be accurately reflected in the displayed quotes of market participants. Because access fees are currently imposed in amounts of less than one cent, requiring access fees to be reflected in the quote necessarily would lead to subpenny pricing. In the Commission's view, the main benefit of displaying quotations in subpenny increments is that displayed quotations would accurately reflect the prices that investors would actually pay, and quote comparability would be achieved. As more fully discussed with respect to the rule proposed to be designated as Rule 612 of Regulation NMS, however, the Commission believes that more widespread use of subpenny quotations would further reduce the depth of liquidity available to investors at any particular subpenny price.[173] In addition, widespread subpenny pricing could very likely exacerbate "stepping ahead" practices, where market participants submit orders that better the displayed quotes by economically insignificant amounts, thereby devaluing price priority and reducing the incentive for aggressive quoting. Furthermore, subpenny pricing could lead to an increase in "flickering quotes," where quotations change so frequently and so rapidly as to engender confusion among investors and complicate the efforts of broker-dealers to comply with their

[173] The Commission's subpenny quoting proposal is discussed in Section V.

regulatory obligations, including the duty of best execution. Accordingly, the Commission does not believe that the potential benefits of displaying subpenny access fees in quotations would justify the costs.

Second, the Commission has considered a "quote normalization" approach that would apply a universal rounding convention to all access fees. Under one such rounding convention, a fee at or smaller than a prescribed amount would be rounded down to zero, and therefore not reflected in the displayed quote, but a fee greater than the prescribed amount would be included in the quote, which would then be rounded away to the next full-penny trading increment. For example, if the fee threshold were set at $.0025 per share, a fee of $.0025 would not be incorporated into the displayed quote of an order to buy at $50.00, but a fee of $.003 would be reflected in the displayed quote and rounded to $49.99. This would reflect the existence of a fee in excess of the threshold in the quoted price. The benefit of this approach is that it could provide an economic incentive for markets to keep access fees below the prescribed level. On the other hand, the Commission believes that this approach could impair price transparency and distort the accuracy of market information, because it would lead to orders being displayed at prices better or worse than the actual price, and perhaps materially so. As noted above, for example, an order to buy at $50.00, posted in an ECN with an access fee at $.003 per share, would be displayed at $49.99, or $.007 lower than the actual net price. On balance, the Commission believes that the benefits of adopting this quote normalization approach would not justify the costs.

Third, the Commission has considered banning access fees. The main benefits of banning access fees are that quotes would be fully comparable throughout the NMS, and would accurately reflect the price. This is consistent with the guiding principles set forth in Section

11A of the Exchange Act.[174] Currently, however, the business models of many ECNs depend on access fees. In addition, exchanges charge various transaction fees for accessing the liquidity in their markets. The Commission believes that the complete elimination of these fees could impair the operation of these markets, thereby reducing competition among market centers within the NMS. Accordingly, the Commission does not believe, on balance, that the benefits of an absolute ban on access fees would justify the potential economic costs to the markets.

Finally, the Commission considered, and is today proposing, the establishment of a de minimis fee standard. This alternative is discussed in full detail below.

iii. Proposed Solution: A de minimis Fee Standard

Under the rule proposed to be designated as Rule 610 of Regulation NMS, all quoting market centers, quoting market participants, and broker-dealers that display attributable quotes through SROs would be permitted to impose fees for the execution of orders.[175] Under the proposed rule, access fees would be limited to a de minimis amount: access fees charged by any individual market participant would be capped at $0.001 per share, and the accumulation of these fees would be limited to no more than $.002 per share in any transaction.[176] This proposed access fee standard is designed to promote a common quoting convention that would harmonize quotations and facilitate the ready comparison of quotes across the NMS. As discussed more fully in Section V, quoting market centers, quoting market participants, and broker-dealers would not be permitted to reflect these subpenny access fees in their quotations.

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174 See Section 11A(a)(1) of the Exchange Act, 15 U.S.C. 78k-1(a)(1).

175 An attributable quote would disclose the identity of the quoting market center, quoting market participant, or broker-dealer that publishes the quote. See, e.g., NASD Rule 4701(c).

176 For securities priced at less than $1.00, a fee standard of .1% of the share price would apply, with fees aggregating to no more than .2% of the share price.

The proposed rule would allow an SRO's order interaction facility to charge a maximum fee of $0.001 per share for access to its market. Market makers, specialists, ATSs, and other broker-dealers that display attributable quotes through SROs would also be permitted to charge a maximum fee of $0.001 per share for access to their quotes, and would be permitted to charge this access fee in addition to any access fee that the SRO also imposes on the transaction.

Under the proposed rule, a customer might incur more than one charge on a single transaction because an SRO would be permitted to impose a fee for access to its order interaction facility and a broker-dealer would be permitted to impose a fee for access to its quotes. The proposed rule would limit the accumulation of these charges in any single transaction to no more than $.002 per share. In the Commission's view, limiting access fees to a de minimis amount -- would promote intermarket access, the standardization of quotations, and the Commission's goals for the NMS.

The proposed rule also would prohibit a quoting market center or quoting market participant from charging a non-member, non-subscriber, or non-customer a fee for indirect access to the quoting market center or quoting market participant through a member, subscriber, or customer, although the member, subscriber, or customer could be charged the standard access fee. The proposed rule would not address the price or other contractual terms that a member, subscriber, or customer of a particular quoting market center or quoting market participant may establish with third parties seeking access. Further, the rule would not restrict SROs or broker-dealers from rebating all or a portion of the permissible access fees to their members, subscribers, or customers.

4. Locked and Crossed Markets

The Commission also believes that repeated or continual locking or crossing of a market may raise concerns about the orderliness and efficiency of the markets. Quotes represent prices at which market participants stand ready to trade. When the bid and offer quotes are displayed at the same price, this indicates either that one or the other's quote is not valid, that brokers are not diligently representing their clients, or that inefficiencies exist that deter trading with the quoting market. As a result, locked quotes can cause confusion regarding reliability of the displayed quote, and create difficulty for market participants seeking best execution for customer orders.

As trading in Nasdaq stocks becomes more dispersed, the resulting reduction in interaction between orders displayed in competing market centers has increased the opportunity for locked and crossed markets. If trading in NYSE and Amex securities becomes more fragmented without being subject to ITS or other locked and crossed provisions, locked or crossed markets could increase in those securities. Accordingly, the proposed rule would require every SRO to establish and enforce rules requiring its members to avoid locking or crossing the quotations of quoting market centers and quoting market participants. For example, these SRO rules may include so-called “ship and post” procedures that would require a market participant to attempt to execute against a displayed order before posting a quote that may lock or cross the market. Under the proposal, the SRO rules also would be required to prohibit members from engaging in a pattern or practice of locking or crossing the quotations in any security.

The Commission recognizes that locked and crossed markets between competing market centers can occur accidentally. For instance, quotes may inadvertently lock or cross when two markets are changing their quotes simultaneously. Accordingly, the proposed rule would require each SRO to promulgate rules that would discourage market participants from engaging in

locking and crossing, but nonetheless would tolerate some minimal incidents of locked and crossed markets.

Accidental locks often are resolved quickly. Quotes also may lock, however, because one or both quotes have an access fee attached, which increases the net price of trading with that quote, and creates an undisclosed spread. Quotes also may lock due to the different speeds of market centers. Automated markets change their quotes frequently as quotes are executed and new orders are displayed. Other markets that rely heavily on human traders to quote and trade may not adjust their quotations as quickly, and these quotes may become stale. At times, automated markets may lock the quotes of manual markets instead of attempting to trade with those quotes.

The Commission requests comment on the extent of the concerns arising from locked markets in particular. Some market participants say that locked quotes convey useful price information, and the ability to lock quotes enables markets to efficiently communicate their trading interest. In addition, the problem of apparent locked markets resulting from quotes with access fees attached may be reduced by the adoption of the other access provisions of proposed Regulation NMS. For example, if quoting market centers and quoting market participants have fair access to each others' quotations, and access fees are limited to de minimis levels, the economic incentives that currently encourage locked markets may diminish. Similarly, as automated executions become more prevalent, there may be less reason to lock a displayed quote. Therefore, the Commission requests comment on the necessity of adopting restrictions on locked markets in the light of the proposed provisions governing intermarket access and access fees.

The Commission also recognizes that for fully-electronic markets the ability to display a quote at a price is a prerequisite to trading at that price. Accordingly, as an alternative to the locked-and-crossed markets rule as currently proposed, the Commission requests comment as to whether there should be an exception from the locking provisions of proposed Regulation NMS for quotes of automated markets that lock quotes of manual markets. More broadly, the Commission also requests comment on whether the scope of the anti-locking and anti-crossing provisions of proposed Regulation NMS should be limited to situations in which trade-throughs would be prohibited. For instance, should locked markets be permitted generally, and should market participants be allowed to enter crossing quotations in situations where the proposed trade-through rule would allow a quote to be traded through?

C. Proposed Amendments to Fair Access Standard under Regulation ATS

Under Regulation ATS, an ATS with at least 5% of the trading volume in a security is required to provide its best bids and offers to a national securities exchange or a national securities association.[177] The Commission believes that access to these quotations is no less important than access to other quotations available in the NMS. Currently, Regulation ATS requires that ATSs with at least 20% of the trading volume in a security maintain standards ensuring that they will not unfairly discriminate or unreasonably deny access to their systems.[178] In conjunction with the proposed new standards governing intermarket access, the Commission is proposing to lower this "fair access" threshold in Regulation ATS from 20% to 5% in order to ensure that the quotes of all significant market participants are accessible throughout the NMS. The Commission also believes that establishing a single 5% threshold for both the transparency

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[177] See Rule 301(b)(3) of Regulation ATS, 17 CFR 242.301(b)(3).

[178] See Rule 301(b)(5)(i) of Regulation ATS, 17 CFR 242.301(b)(5)(i).

and access standards of Regulation ATS will encourage fair competition between ATSs with significant internal trading volume. The Commission requests comment on whether the fair access standard should be expanded to apply to all ATSs that voluntarily provide their quotes to a national securities exchange or registered securities association for inclusion in the public quotation stream, irrespective of an ATS's percentage of trading volume.

D. General Request for Comment

The Commission seeks comments on the access proposal described above. The Commission asks commenters to address whether the proposed new rules relating to access to published bids and offers would further the NMS goals set out in Section 11A of the Exchange Act.[179]

Furthermore, the Commission requests that interested persons respond to the following specific questions:

- Are the proposed rules an appropriate response to the need for access between markets and the concerns raised by access fees and locked and crossed quotes?
- Is reliance upon private, negotiated agreements between members and nonmembers adequate to ensure intermarket access to competing pools of equity liquidity throughout the NMS?
- Would the proposed limitation on disparate treatment of indirect access provide sufficient access to all quoting market centers through broker-dealers and routing systems? How would the proposal affect ECN-subscriber relationships?

[179] 15 U.S.C. 78k-1.

- Should the Commission mandate automatic execution -- requiring that quotes be fully and immediately accessible at their full size -- as part of its proposed access standards ? If so, why? If not, why not?
- Should any such automatic execution requirement be limited to the best bid and offer?
- Do the proposed rules adequately address the concerns that have arisen with respect to access fees? If not, what rules would do so?
- Would the establishment of a de minimis standard on access fees be a desirable means of ensuring the comparability of quotes for stocks trading at prices of $1.00 or more per share and, if so, is the $.001 ($.002 in the aggregate) threshold appropriate? If not, what means would be desirable?
- Is the establishment of a de minimis standard on access fees a desirable means of ensuring the comparability of quotes for stocks trading at prices of less than $1.00 per share, and, if so, is the fee standard of .1% (.2% in the aggregate) appropriate?
- Would the proposed de minimis standards interfere unnecessarily with the business models of ECNs, national securities associations, and national securities exchanges? Are there other, less intrusive ways of dealing with the concerns that have arisen with respect to access fees? If so, what are they?
- Would the proposed new access provisions, quotation standardization, and new SRO responsibilities with respect to locked and crossed markets appropriately and effectively address the current problems with respect to locked and crossed markets? If not, why not and what would accomplish this goal instead?

- Would the establishment of a lower 5% "fair access" threshold under Regulation ATS be necessary and appropriate to accomplish the Commission's stated goals? If not, why not? Would a threshold higher or lower than 5% be appropriate? If so, why?
- Finally, the Commission requests comment on whether, if it were to adopt the proposed new access provisions, a phase-in period would be necessary or appropriate to allow market participants time to adapt to them. If so, what aspect or aspects of the proposed provisions should be phased in, and what would be the appropriate phase-in period?

The Commission recognizes that intermarket access presents a number of complex problems to which there may be many possible solutions. Interested persons may wish to propose and discuss specific, alternative approaches to intermarket access that the Commission should consider as it seeks to accomplish its goal of strengthening the NMS. Commenters may also wish to discuss whether there are any reasons why the Commission should consider an alternative approach.

E. Paperwork Reduction Act

The Commission does not believe that the proposed new access rule contains any collection of information requirements as defined by the Paperwork Reduction Act of 1995, as amended, but the Commission encourages comments on this point. The Commission notes that the requirement under the rule proposed to be designated as Rule 610(c) that each exchange and association must establish and enforce rules that would require members reasonably to avoid locking or crossing the quotations of quoting market centers and quoting market participants would necessitate that each exchange and association keep records of locked and crossed quotations for surveillance purposes. However, as each market already has established rules and procedures for avoiding intra-market locking and crossing, and national securities exchanges,

national securities associations, and broker-dealers participating through Nasdaq in the ITS Plan all have rules prohibiting inter-market locks and crosses for listed securities, the Commission believes that these requirements are minimal. This information would be derived from information that Section 17(a) of the Exchange Act and Rule 17a-1 thereunder already require be kept and preserved. The Commission is cognizant, however, that the new rule proposed to be designated as Rule 610(c) would require each exchange and association to use such information in a different manner, as by the creation of an additional report concerning locked and crossed quotations. Accordingly, the Commission solicits comment on this point.

The Commission also does not believe that the proposed amendment to Regulation ATS contains any collection of information requirements as defined by the Paperwork Reduction Act of 1995, as amended, but the Commission encourages comments on this point. The proposed amendment to Regulation ATS would extend the fair access requirements of Regulation ATS to all ATSs with at least 5% of the trading volume in a particular security. The Commission believes that this amendment will affect fewer than ten ATSs. Accordingly, the Commission believes that the amendment imposes no new collection of information requirements. The Commission encourages comments on this point.

F. Consideration of Costs and Benefits

As discussed above, the Commission is proposing a new rule that would require SROs and other quoting market centers and quoting market participants to permit all market participants access to their trading books. In addition, in order to standardize quotations, the proposed new rule would enable quoting market centers, quoting market participants, and broker-dealers to charge de minimis fees for access to their quotations, establish common

quoting conventions for bids and offers, and create a mechanism for reducing the incidence of locked and crossed markets.

The Commission has preliminarily determined that quote standardization would reduce the disparity that currently exists between the publicly displayed quotation and the actual price (including access fees) that is charged. The Commission believes that both investors and professional traders would benefit from this improved transparency. Also, by eliminating the disparity between the posted quotation and the execution price, the Commission believes that the execution cost associated with a transaction may be reduced for the ultimate benefit of individual investors. This would also be the case with the anti-locking and anti-crossing provisions, which would allow for more transparent pricing and better information that would inure to the benefit of individual investors.

The proposal may adversely affect the limited number of ATSs that currently charge high access fees. Such ATSs would most likely be required to re-evaluate their business plans in light of the proposed quote standardization regime. Market makers would also be allowed to charge access fees directly. The Commission believes that this would further add to market transparency and allow market makers to compete with ATSs on more equal terms. High-volume ATSs, national securities exchanges, and Nasdaq would have to make minor to modest adjustments but would not, in the Commission's view, be significantly affected by the proposal.

The Commission has identified below certain additional costs and benefits to the proposed new access rule. The Commission requests comment on all aspects of this proposed cost-benefit analysis, including identification of additional costs or benefits of the proposed changes. The Commission encourages commenters to identify or supply any relevant data concerning the costs or benefits of the proposed rule.

1. Benefits

In carrying out its oversight of the NMS, the Commission seeks to serve the interests of investors by proposing rules designed to ensure that securities transactions can be executed efficiently, at prices established by vigorous and fair competition among market centers. The Commission believes that such access to diverse marketplaces within a unified national market would foster efficiency, enhance competition and contribute to the "best execution" of orders for qualified securities.

The proposed new rule would establish common quoting conventions and entitle market participants to full access to the limit order books of quoting market centers and quoting market participants on a non-discriminatory basis. The Commission believes that the new access standards would increase transparency and enhance confidence in the markets. The Commission also believes that the proposed rule would promote interaction among markets, reduce the effects of fragmentation, and lower the costs to investors.

The Commission believes that, by establishing a uniform standard governing the terms of access among or between competing market centers, the proposed rule would assist broker-dealers in complying with their best execution obligations by enabling them to route customers' orders to the market with the best price. The Commission also believes that the proposed rule would alleviate the growing problem of locked and crossed quotations in the NMS. Finally, the Commission believes that the lowering of the fair access threshold under Regulation ATS to 5% of trading volume in a particular security should help to assure that all significant market participants meaningfully participate in the NMS.

The Commission seeks comment on these benefits, as well as any additional benefits of the proposed new access standards.

2. Costs

The Commission recognizes that the proposed rule would impose costs on quoting market centers and quoting market participants, including national securities exchanges and national securities associations. SROs and other market centers would incur costs associated with any systems changes necessary to comply with the requirement that they permit all market participants access to their trading books. Likewise, all broker-dealers that currently do not make their quotations available to all other market participants on a non-discriminatory basis would incur costs associated with systems changes to comply with this requirement of the proposed rule. In addition, in both cases, the quotation standardization provision of the proposed rule could result in a reduction in the fees currently charged by quoting market centers.

In addition, every exchange and association would be required to establish and enforce rules requiring their members to avoid locking and crossing quotations. To the extent that an SRO may require rule changes to comply with the proposed rule, there would be regulatory costs. However, as each market already has established rules and procedures for avoiding intra-market locking and crossing, and national securities exchanges, national securities associations, and broker-dealers participating through Nasdaq in the ITS Plan all have rules prohibiting inter-market locks and crosses for listed securities, the Commission believes that these requirements are minimal. Moreover, market centers would need to develop and maintain surveillance programs to detect when a locked or crossed quotation has occurred, as well as disciplinary procedures addressed to those who engage in a pattern or practice of locking or crossing quotations. Finally, the proposed amendment to Regulation ATS would extend Regulation ATS's requirements to all ATSs with at least 5% of the trading volume in a particular security. The Commission expects that most ATSs will not have sufficient volume to trigger this threshold

and will therefore not have to comply with this provision. Those ATSs that do trigger this threshold would likely incur costs associated with systems changes and regulatory costs to comply with Regulation ATS.

The Commission seeks comment on any additional costs of the proposed new access standards.

F. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act[180] requires the Commission, whenever it engages in rulemaking and must consider or determine if an action is necessary or appropriate in the public interest, also to consider whether the action would promote efficiency, competition, and capital formation. Section 23(a) of the Exchange Act likewise requires the Commission to consider the impact such rules would have on competition.[181] Specifically, Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The proposed access rule is intended to address the absence of a uniform standard governing access to quotations and the execution of orders for equity securities throughout the NMS. The proposed rule would require SROs and other quoting market centers and quoting market participants to permit all market participants access to their limit order books, establish common quoting conventions for bids and offers, enable quoting market centers and quoting market participants, including broker-dealers, to charge de minimis fees for access to their quotations, and create a mechanism for reducing the incidence of locked and crossed markets.

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[180] 15 U.S.C. 78c(f).

[181] 15 U.S.C. 78w(a).

The Commission believes that the proposed new access standards would bolster investor confidence in the markets by helping to ensure investors that their orders are executed at the best prices and are subject to no hidden fees, regardless of the market on which the execution takes place. The Commission further believes that the proposed rule would establish common quoting conventions that would increase transparency in the market, thereby enhancing investor confidence, and thus capital formation. Moreover, the Commission believes that the proposed rule would encourage interaction between the markets and reduce fragmentation by removing impediments to the execution of orders between and among marketplaces thereby increasing efficiency and competition.

The Commission also believes that the proposed rule would assist broker-dealers in evaluating and complying with their best execution obligations. Finally, the proposed rule would cause markets to strive to reduce locking and crossing of quotations on their markets. The Commission believes that this should increase the efficiency of the markets.

The Commission requests comment on whether the proposed rules are expected to promote efficiency, competition, and capital formation.

G. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act,[182] the Commission must advise OMB as to whether the proposed regulation constitutes a "major" rule. A rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);

[182] Pub. L. No. 104-121, title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C., and as a note to 5 U.S.C. 601).

- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effect on competition, investment or innovation.

If a rule is “major,” its effectiveness will generally be delayed for 60 days pending Congressional review.

The Commission requests comment on the potential impact of the proposed regulation on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

H. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA") in accordance with the provisions of the Regulatory Flexibility Act ("RFA")[183] with respect to the proposed new access standards.

The proposed new access standards would require SROs and other market centers to permit all market participants access to their limit order books. In addition, the proposed rule would enable market centers and broker dealers to charge de minimis fees for access to their quotations, establish common quoting conventions for bids and offers, and create a mechanism for reducing the incidence of locked and crossed markets.

1. Reasons for the Proposed Action

In recent years, there have been significant changes in the way the markets operate and compete with each other. New technological advances have resulted in automated quoting and handling of orders, and new market participants have emerged with new business models. Some market centers operate entirely electronically, while others continue to conduct floor-based

[183] 5 U.S.C. 603.

trading. With the advent of trading in decimals, the minimum pricing variation in equity securities has narrowed and there is often less depth at the top-of-book.

Currently, although multiple trading venues seek to attract order flow by competing over price, speed of execution, and other significant factors, there are few regulatory standards governing the routing and execution of orders among or between competing market centers. The Commission believes that it is time to establish standards governing access to quotations and the execution of orders for equity securities throughout the NMS. The Commission believes that ensuring access to diverse marketplaces within a unified national market would foster efficiency, enhance competition, and contribute to the "best execution" of orders for NMS securities.

2. Objectives and Legal Basis

The proposed new access standards are designed to achieve several objectives. The Commission believes that the proposed new access standards would give market participants access to the prices and liquidity found on competing market centers. The Commission also believes that the proposed new access standards would assist broker-dealers in evaluating and complying with their best execution obligations. Finally, the Commission believes that the proposed rule would alleviate the growing problem of locked and crossed markets in the NMS.

The Commission is proposing the new access standards under the authority set forth in Sections 3(b), 5, 6, 11A, 15, 15A, 17(a) and (b), 19, 23(a) and 36 of the Exchange Act.

3. Small Entities Subject to the Rules

The proposed new access standards are designed to apply to any national securities exchange or national securities association that provides an order execution facility, or any alternative trading system or other broker- dealer that displays its quotes other than on an national securities exchange or national securities association order execution facility. These

entities would be required to adopt rules and procedures that would comply with the requirement that they permit all market participants with access to their trading books or quotations, as appropriate, on a non-discriminatory basis. In addition, these entities may be required to revise their fees to comply with the quotation standardization provision of the proposed rule.

In addition, every exchange and association would be required to establish and enforce rules requiring their members to avoid locking and crossing quotations. The market centers would need to develop and maintain surveillance programs to detect when a locked or crossed quotation has occurred, as well as penalties to discipline those who engage in a pattern or practice of locking or crossing quotations. The proposed rule would also extend Regulation ATS's requirements to all ATSs with at least 5% of the trading volume in a particular security. Those ATSs would likely need to adopt procedures to comply with Regulation ATS.

The proposed rule is intended to reach a wide variety of market participants. Each is discussed below.

a. National Securities Exchanges and National Securities Association

None of the national securities exchanges is considered a small entity as defined by Commission rules. Rule 0-10(e) under the Exchange Act[184] states that the term "small business," when referring to an exchange, means any exchange that has been exempted from the reporting requirements of Rule 11Aa3-1 under the Exchange Act. There is one national securities association, which is not a small entity as defined by 13 CFR 121.201.

b. Alternative Trading Systems

There are 12 ATSs that are considered small entities.

c. Broker-Dealers and Exchange and OTC Market Makers

[184] 17 CFR 240.0-10.

Commission rules generally define a broker-dealer as a small entity for purposes of the Exchange Act and the RFA if the broker-dealer had a total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, and the broker-dealer is not affiliated with any person (other than a natural person) that is not a small entity.[185] The Commission estimates that as of December 31, 2002, there were approximately 880 Commission-registered broker-dealers that would be considered small entities for purposes of the statute that would be required to comply with the proposed rule's provisions regarding access to quotations and quotation standardization.

4. Reporting, Recordkeeping, and other Compliance Requirements

The proposed new access standards would require every exchange and association to establish and enforce rules requiring their members to avoid locking and crossing quotations. The market centers would need to develop and maintain surveillance programs to detect when locked or crossed quotations have occurred, as well as disciplinary measures to apply as necessary or appropriate. In addition, Regulation ATS would require that all ATSs with at least 5% of the trading volume in a particular security maintain records with respect to grants, denials and limitations of access.

5. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission has not identified any rules that duplicate, overlap, or conflict with the proposed rules.

6. Significant Alternatives

Pursuant to Section 3(a) of the RFA, the Commission must consider the following types of alternatives: (a) the establishment of differing compliance or reporting requirements or

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[185] 17 CFR 240.0-10(c)

timetables that take into account the resources available to small entities; (b) clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the proposed rule, or any part thereof, for small entities.

The Commission believes that different compliance or reporting requirements or timetables for small entities would interfere with achieving the primary goal of establishing standards governing access to quotations and the execution of orders for equity securities throughout the NMS. If all market participants, regardless of size, are not obligated to comply with the proposed new access standards, investors that are customers of small broker-dealers, and market participants seeking to access the quotations and liquidity of such small broker-dealers, would not benefit fully from the rule, potentially reducing the benefits of the rule. The Commission also does not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed rule as the rule already proposes performance standards and does not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed rule.

7. Solicitation of Comments

The Commission encourages the submission of comments with respect to any aspect of this IRFA. In particular, the Commission requests comments regarding: (1) the number of small entities that may be affected by the proposed rules; (2) the existence or nature of the potential impact of the proposed small entities discussed in the analysis; and (3) how to quantify the impact of the proposed rules. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in

the preparation of the Final Regulatory Flexibility Analysis, if the proposed rule is adopted, and will be placed in the same public file as comments on the proposed rule.

V. Sub-Penny Quoting Proposal

A. Introduction

In April 2001, the U.S. equity markets completed the conversion from pricing in fractions to pricing in decimals. This conversion has reduced trading costs through narrower spreads, made equity pricing easier to understand, and aligned the pricing of securities on U.S. markets with major markets abroad, which were the Commission's primary goals in directing the markets to make the conversion.[186]

As part of the conversion to decimals, each of the major markets established a minimum quoting increment of at least $0.01, which the Commission approved.[187] More recently, however, there has been a growing trend in the industry, particularly among ECNs, to display quotations in their proprietary systems in "sub-pennies" (i.e., increments finer than a penny). These sub-penny quotes may be superior to the best quotes displayed on Nasdaq and the exchanges, but such quotes are currently rounded to the nearest penny by the markets and securities information processors, and therefore are not included in the quotation data that is

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186 See, infra Part V.B.2 for a further discussion of the impact of the decimals conversion.

187 Securities Exchange Act Release No. 46280 (July 29, 2002), 67 FR 50739 (August 5, 2002) (order approving proposed rule changes and amendments related to decimal pricing). In this Order, the Commission approved the proposals of Amex, BSE, CBOE, CHX, the exchange then known as Cincinnati Stock Exchange, Inc., subsequently renamed the "National Securities Exchange" ("CSE"), ISE, NASD, NYSE, PCX, and Phlx (collectively, "Participants") to establish a minimum price variation (MPV) of $0.01 for equity issues, $0.05 for option issues quoted under $3.00 a contract, and $0.10 for option issues quoted at $3.00 a contract or greater ("July 2002 Order").

disseminated to the public.[188] Therefore, this information often may not be accessible to the average investor. Nevertheless, many broker-dealers access these sub-penny quotes either to fulfill their best execution obligation to their customers or simply to obtain better prices than they could through the exchanges or Nasdaq. This access is often facilitated by order management tools that allow market participants automatically to route orders based on the best price available in the market, even if that price is merely a fraction of a cent better than the best publicly displayed price in the market. As a result, the exclusion of sub-penny pricing from the disseminated quotation data effectively is creating "hidden markets" where securities trade in prices not transparent to the general public.

In addition, recent economic research conducted by Commission staff and by Nasdaq suggests that market participants may use sub-penny quoting more as a means to "step ahead" of competing limit orders for an economically insignificant amount to gain execution priority, than as an extrinsic expression of trading interest.[189] If so, sub-penny pricing could discourage market participants from using limit orders, which could deprive the markets of an important source of liquidity.

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188 The Commission staff had provided a no-action letter in 1997 to Nasdaq for ECNs and market makers to handle orders priced in increments smaller than 1/16th in Nasdaq securities without having consolidated quotations reflect that bids or offers had been rounded. See Letter to Robert Aber, Vice President and General Counsel, Nasdaq, from Richard R. Lindsey, Director, Division of Market Regulation (July 31, 1997). While the orders were rounded for quotation purposes, the trades were reported and printed in the actual price increments. See also Letter to Paul O'Kelley, Chief Operations Officer, CHX, from Annette L. Nazareth, Director, Division of Market Regulation, Commission (April 6, 2001) (providing similar relief for CHX specialists and market makers); Letter to Jeffrey T. Brown, Senior Vice President and General Counsel, CSE, from Robert L.D. Colby, Deputy Director, Division of Market Regulation, Commission (July 26, 2002) (providing similar relief to CSE members).

189 See, infra Part V.D.2.c. for a further discussion of Nasdaq's economic study; see also, infra Part V.E. for a further discussion of an economic study prepared by SEC staff. These studies may both be accessed in the Commission's Public Reference Room.

Sub-penny trading has increased since the implementation of decimals, and Nasdaq recently filed a proposal with the Commission that would allow securities that trade through Nasdaq systems to be quoted in $0.001 increments. This proposal, if approved, could lead to widespread sub-penny quoting. Simultaneous with this proposal, Nasdaq also filed a petition for Commission action with the Commission, upon which the Commission seeks comment below, in which Nasdaq requests that the Commission adopt a uniform rule requiring market participants to quote and trade Nasdaq securities in a "consistent monetary increment," with certain exceptions.[190]

The Commission is concerned that the status quo, where superior sub-penny quotes on alternative markets are not transparent to and may not be readily accessible to average investors, may be harmful to those investors and to the markets as a whole. At the same time, the Commission believes that including those sub-penny quotes in the best publicly disseminated prices could harm investors and the markets. Among other things, and as described in more detail below, sub-penny quoting is likely to decrease further market depth (i.e., the number of shares of a security that is available at any given price), increase the incidence of market participants stepping ahead of standing limit orders for an economically insignificant amount, and make it more difficult for broker-dealers to meet certain of their regulatory obligations by increasing the incidence of so-called "flickering" quotes. Moreover, the Commission is concerned that the potential benefits of marginally better prices that sub-penny quotes might offer in securities priced above $1.00 per share are not likely to justify the costs that would result

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190 See Letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, Commission (August 4, 2003) ("Nasdaq Petition") File No. S7-11-03. Although Nasdaq in its petition does not explicitly request that the Commission impose a penny pricing increment, it asserts that implementation of a penny increment for quoting and trading Nasdaq securities would be "prudent." Id. The Nasdaq Petition also may be accessed in the Commission's Public Reference Room.

from such a change. Therefore, the Commission is proposing to prohibit market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment finer than a penny in any NMS stock, other than those with a share price below $1.00.

B. Decimals Conversion

1. Background

In June 2000, the Commission issued an order (the "June 2000 Order") that established the framework for the exchanges and NASD (collectively, the "Participants") to convert their quotation prices in equity securities and options from fractions to decimals.[191] The June 2000 Order permitted the Participants to select a uniform minimum price variation ("MPV") for stock quotations of no greater than $0.05 and no less than $0.01.[192] In July 2000, the NYSE, on behalf of the Participants, submitted to the Commission a "Decimals Implementation Plan" that set the MPV for equity securities quotations at a penny.[193]

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191 See Securities Exchange Act Release No. 42914 (June 8, 2000), 65 FR 38010 (June 19, 2000) ("June 2000 Order"). On January 28, 2000, the Commission had ordered the Participants to facilitate an orderly transition to decimal pricing in the securities markets. Securities Exchange Act Release No. 42360 (Jan. 28, 2000), 65 FR 5004, 5005 (Feb. 2, 2000). In that order, the Commission set a timetable for the Participants to begin trading some equity securities, and options on those securities, in decimals by July 3, 2000, and all equities and options by January 3, 2001. Subsequently, on April 13, 2000, the Commission issued another order staying the original deadlines for decimalization. Securities Exchange Act Release No. 42685 (April 13, 2000), 65 FR 21046 (April 19, 2000).

192 Securities Exchange Act Release No. 42914, 65 FR at 38013. The Order noted: "There was little agreement among the commenters regarding a minimum quoting increment during the phase-in period; suggestions ranged from a dime to a penny. As a result, the phase-in plan may fix the minimum quoting increment during the phase-in periods, provided that the minimum increment is not greater than five cents and no less than one cent for any equity security, and that at least some equity securities are quoted in one cent minimum increments."

193 See letter from Dennis L. Covelli, Vice President, NYSE, to Annette Nazareth, Director, Division of Market Regulation, Commission (July 25, 2000). Due to capacity limitations in quoting and trading options, however, the Decimals Implementation Plan selected

The June 2000 Order established two other requirements. First, it required the Participants to submit to the Commission studies analyzing how the decimals conversion had affected systems capacity, liquidity, and trading behavior, including an analysis of whether there should be a uniform price increment for all securities. Results of the studies submitted by Nasdaq and by NYSE are discussed below.[194] Second, the order required the Participants to submit rule filings to the Commission that would individually establish an MPV for each market quoting equity securities and options. In these filing, the Participants established minimum quoting increments of $0.01 for equity securities.[195]

2. Impact of the Decimals Conversion

The markets completed the decimals conversion by April 9, 2001, and the Commission believes that the goals of decimalization-- to simplify pricing for investors, make U.S. markets more competitive internationally, and potentially reduce trading costs (in terms of spreads)-- appear to have largely been met. In addition to making securities pricing easier to understand and consistent with the pricing increments on major markets abroad, decimals (and specifically the move to a penny MPV for equity securities) have reduced spreads, thus resulting in reduced trading costs for investors entering orders --particularly smaller orders-- that are executed at or within the quotes.[196]

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uniform MPVs for quoting options of $0.05 for options quoted under $3.00 and $0.10 for options at $3.00 or greater.

194 Overall, there were nine such studies prepared by the Participants. In addition, CHX commissioned a study.

195 See July 2002 Order, supra n. 187. The Order also established a $0.05 MPV for option issues quoted under $3.00 a contract and a $0.10 MPV for option issues quoted at $3.00 a contract or greater.

196 Id.

For example, Nasdaq conducted a study on the impact of the decimal conversion on Nasdaq-listed securities and found that quoted and effective spreads fell by an average of about 50% from the period before the decimal conversion to the period after decimal pricing was implemented.[197] Nasdaq also found that small retail orders benefited the most from reduced spreads due to the decimal conversion.[198] Nasdaq also witnessed no increase in intraday volatility.

NYSE conducted a similar study for NYSE-listed securities and reported similar results, noting that quoted spreads fell to less than half their pre-decimal average size, and effective spreads were, on average, 43% lower.[199] NYSE found that net price improvement rose 29%.

Despite these benefits, this fundamental change did not come without costs. For example, Nasdaq found that the quoted size posted at the inside price (the "depth") fell by about

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197 The Nasdaq Stock Market, Inc., The Impact of Decimalization on the Nasdaq Stock Market; Final Report to the SEC Prepared By Nasdaq Economic Research (June 11, 2001) at 4 ("Nasdaq Decimals Report"). The quoted spread is the difference between the national best ask price and the national best bid price. The effective spread is twice the absolute difference between the midpoint of the bid-ask spread and the price paid (or received) by investors, and accounts for trading that occurs at prices other than the quoted prices.

198 Nasdaq found that effective spreads for small trades fell by about 46%, whereas those for larger trades (i.e., those over 2000 shares) fell by 27%. Nasdaq Decimals Report, supra note 197 at 16.

199 Decimalization of Trading on the New York Stock Exchange: A Report to the Securities and Exchange Commission, (Sept. 7, 2001) ("NYSE Decimals Report"). The July 2002 Order cited prior OEA studies indicating that some of the anticipated benefits of decimalization, such as the significant narrowing of quoted spreads, were evident almost immediately. For example, OEA estimated that, from December 2000 to March 2001, quoted spreads for NYSE-listed securities narrowed an average of 37%. An even more dramatic reduction in quoted spreads was observed in Nasdaq-listed securities, with spreads narrowing an average of 50% following decimalization. These results were consistent with those found in other studies. See, e.g., Bessembinder, 2003, Trade Execution Costs and Market Quality After Decimalization, Journal of Financial and Quantitative Analysis, 38(4) (finding narrower average quoted, effective, and realized bid-ask spreads, and lower volatility post-decimalization).

two-thirds (although cumulative displayed depth fell by a smaller amount).[200] It also found that the number of quote updates for the securities studied increased by 12% or more after controlling for the day-to-day fluctuation in trading activity, which indicates a negative impact on systems capacity.[201]

Moreover, NYSE also found that the quoted size posted at the inside or best price for NYSE-listed securities fell by about two-thirds.[202] In addition, the number of orders received on NYSE systems more than doubled, and the number of trades rose 76%. NYSE found that the typical transaction size fell, with the average size of limit orders declining 21%. Finally, NYSE found that many more limit orders were cancelled following decimalization, namely 42.4% compared to 34.2% pre-decimals, which could be the result of faster-moving quotes.[203]

C. Sub-Penny Concept Release

On balance, the Commission believes that the benefits of decimals to investors and to the markets have justified the costs. Nevertheless, as the pricing increment for equity securities

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200 Nasdaq Decimals Report, supra note 197 at 2, 33-37. Quoted depth refers to displayed depth at the NBBO whereas cumulative depth measures aggregated depth at various price levels relative to the quote midpoint. Nasdaq noted that the fall in quoted size could be explained, at least in part, by a decline in the use of limit orders after decimals.

201 Nasdaq noted, however, that the move to decimals did not cause unmanageable increases in message traffic. Id.

202 NYSE Decimals Report, supra note 199 at 2, 9.

203 Other studies examined the effects of decimalization on the NYSE. See Bacidore, Battalio, and Jennings, 2003, Order Submission Strategies, Liquidity Supply and Trading in Pennies on the New York Stock Exchange, Journal of Financial Markets, 6(3), 337-362 (finding that the average size of non-marketable limit orders fell in the post-decimals period, limit order cancellation rates rose significantly in the post-decimal sample period, and quoted depth fell dramatically). See also Chakravarty, Wood, and Van Ness, Decimals and Liquidity: A Study of the NYSE, Journal of Financial Research, forthcoming (finding that quoted depth as well as quoted and effective bid-ask spreads declined significantly following decimalization and that the number of trades and trading volume declined significantly).

decreases beyond a certain level, the potential costs to investors and the markets may increase and could, at some point, surpass any potential benefit of permitting securities to be quoted in finer increments.

In July 2001, to assist the Commission in determining the optimal minimum price increment at which securities should be quoted and traded, the Commission issued a Concept Release seeking public comment on the potential impact of sub-penny pricing.[204] In particular, the Concept Release requested comment on a number of issues, including the potential impact sub-penny pricing might have on (1) market depth (i.e., the number of shares available at a given price), (2) price clarity (e.g., the potential to cause ephemeral or "flickering" quotes), (3) marketplace execution priority rules, and (4) automated systems.

The Commission received 33 comment letters in response to the Concept Release.[205] Commenters included NYSE and three regional exchanges, several broker-dealers and industry groups (including the Securities Industry Association ("SIA") and the Investment Company

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[204] Securities Exchange Act Release No. 44568 (July 18, 2001), 66 FR 38390 (July 24, 2001).

[205] See Letters from Security Traders Association (STA) (1), Wynncroft, Inc. (Wynncroft) (2), Frank Yang (Yang) (3), Dalton Strategic Investment Services (Dalton) (4), Quaker Securities (Quaker) (5), Investor Resources Group (Investor Resources) (6), Sean McGowan (McGowan) (7), Momentum Securities for Electronic Traders Association (ETA) (8), Diamant Investment (Diamant) (9), CHX (10), Advanced Clearing, Inc. (Advanced Clearing) (11), Midwood Securities (12), NYSE (13), Security Traders Association/ECN Subcommittee (STA/ECN) (14), The Rock Island Company (Rock Island) (15), Carl Giannone (Giannone) (16), T. Rowe Price (17), CooperNeff Advisors (CooperNeff) (18), Specialist Association (19), Investment Company Institute (ICI) (20), Securities Industry Association (SIA) (21), Phlx (22), Investment Technology Group, Inc. (ITG) (23), BSE (24), Richard Tsuhara (Tsuhara) (25), Josh Levine (Levine) (26), Knight Trading Group (Knight) (27), J.R. Leming (Leming) (28), Island ECN (Island) (29), The Security Traders Association of New York, Inc. (STANY) (30), ABN Amro Inc. (AAI) (31), Carnes Investment Group (32), and Ameritrade (33). Copies of these letters, as well as a summary of all comments received, may be accessed in the Commission's public reference room under File No. S7-14-01.

Institute ("ICI"), a large ECN, and a number of individuals. The majority opposed sub-penny pricing. Some of those opposing sub-pennies believed that the negative impacts that accompanied trading in decimals would be exacerbated by reducing the MPV even further, without meaningfully reducing spreads or securing other countervailing benefits for the markets or investors. These commenters thus recommended that all quoting and trading of securities have a minimum increment of at least a penny.[206] Some commenters that opposed sub-penny quoting thought trading in sub-pennies should be allowed.[207]

Some commenters believed that the forces of competition, rather than regulation by the Commission or Congress, should determine the minimum increment.[208] These commenters suggested that finer increments could improve market efficiency and provide investors with valuable price improvement. They argued that the problems accompanying decimals could be resolved through technology enhancements, rather than through a market structure overhaul.

Commenters' views on the specific questions solicited in the Concept Release are discussed below.

1. Market Depth

Many commenters noted that the narrower quoted and effective spreads that resulted from decimals came at the expense of a material loss of depth at the best displayed bids and

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206 See Letters from STA (1), Yang (3), Dalton (4), Investor Resources (6), McGowan (7), Midwood Securities (12), NYSE (13), Rock Island (15), Specialist Association (19), and Phlx (22).

207 See Letters from ETA (8), T. Rowe Price (17), ICI (20), SIA (21), ITG (23), Knight (27), and Ameritrade (33).

208 See Letters from CHX (10), STA/ECN (14), Giannone (16), BSE (24), Tsuhara (25), Levine (26), and Island (29).

offers.[209] They contended that the increase in the number of price points to 100, and the spreading of buy and sell interest across these prices, made it more difficult for market participants to ascertain the price of a particular security and assess their chances of being able to obtain an execution at a particular price. Market professionals complained that they were finding it increasingly difficult to gauge market depth at or near the NBBO and to determine how long it would take to complete an order, thus rendering the NBBO less effective in reflecting true trading interest.[210] These commenters believed that the increase in potential price points that would result from sub-penny pricing would exacerbate the problems with diminished depth and liquidity (i.e., the ability to find a buyer or seller at any given price), undermine the orderliness of the markets, and cast further doubt on the accuracy of price discovery.

One commenter countered these arguments, opining that sub-penny opponents may be motivated more by concerns over broker-dealer profitability (which would be expected to fall as spreads decline) rather than broader policy implications of sub-penny pricing.[211]

Two commenters contended that problems with respect to determining depth and liquidity are caused by limitations in the way quotation data is currently disseminated and that these problems have been magnified with decimals.[212] One of these commenters believed that

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209 See Letters from STA (1), Wynncroft (2), ETA (8), Advanced Clearing (11), Midwood Securities (12), NYSE (13), Rock Island (15), T. Rowe Price (17), CooperNeff (18), Specialist Association (19), ICI (20), SIA (21), Phlx (22), and Knight (27).

210 The ICI contended that it was especially difficult to fill entirely at the best displayed prices large orders of mutual funds, pension funds, and other institutional firms, thus resulting in increased transaction costs. The ICI cited, among other studies, Nasdaq's decimal study noting that many market makers indicated that working large institutional orders requires more trades.

211 See Letter from Island (29).

212 See Letters from Levine (26) and Island (29).

one way to address concerns over diminished depth and liquidity would be for markets to display more depth of book information.[213] A commenter suggested that the marketplace would adopt new technologies to deliver market data in a format that accurately represents buy and sell interest, and that what this commenter viewed as the inadequacy of the current NBBO-style quote is not a justification for limiting the size of the MPV.[214]

2. Price Clarity and Flickering Quotes

A number of the commenters believed that the conversion to decimals clarified pricing for investors by allowing them to compare prices to buy and sell stocks in dollars and cents, as opposed to dealing with fractions. They contended, however, that sub-pennies would lead to confusing prices by causing quotes to change rapidly or "flicker."[215] They argued that flickering quotes could interfere with investors' understanding of securities prices, impair broker-dealers' efforts to obtain best execution for customers' orders, make it harder to compare execution quality among market centers, and increase the incidence of locked and crossed markets and trade-throughs.[216]

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213 See Letter from Island (29). Island noted that it showed its 15 best orders on its system. ICI (20) noted that, if securities were quoted in sub-penny increments, being able to view the top of the book or even the entire book would be insufficient to provide investors with enough information about the trading interest in a particular security because investors could be using fewer limit orders.

214 See Letter from Levine (26).

215 See Letters from STA (1), Dalton (4), Investor Resources (6), Diamant (9), STA/ECN (14), Rock Island (15), Giannone (16), SIA (21), and BSE (24).

216 See Letters from NYSE (13), T. Rowe Price (17), Specialist Association (19), ICI (20), SIA (21), Phlx (22), and BSE (24).

Two commenters that favored sub-penny pricing disputed the arguments of those opposing it.[217] They disagreed with the view that quote flickering is necessarily a negative result, arguing that quickly changing, accurate, timely prices are desirable features of an efficient market. Moreover, these commenters believed that rapidly changing price information can be presented in a comprehensible manner, such as through graphical displays.

3. Execution Priority Rules

The Concept Release also sought comment on the impact, if any, sub-penny pricing would have on the markets' execution priority rules.[218] The majority of commenters believed that "stepping ahead" or "pennying" (i.e., attempting to gain execution priority by improving the best bid by a penny) had increased with the advent of decimals and that this problem would be exacerbated with sub-pennies.[219]

One commenter believed that sub-penny pricing would erode price priority in the markets by encouraging institutions and professional traders to "jump the queue" to achieve priority over pending orders for a marginally better price without taking a meaningful economic risk.[220] Another commenter stated that such activity deters market participants from displaying large

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217 See Letters from Levine (26) and Island (29).

218 Commission and SRO rules provide customer limit orders with priority over specialist and market maker orders at the same price on the exchanges and on Nasdaq. See, e.g., 17 CFR 240.11a1-1(T); NYSE Rule 92(b), and NASD's Manning Interpretation (NASD IM-2110-2).

219 See Letters from STA (1), Yang (3), Quaker (5), Diamant (9), Advanced Clearing (11), Midwood (12), NYSE (13), STA/ECN (14), Rock Island (15), Giannone (16), Specialist Association (19), ICI (20), SIA (21), Phlx (22), BSE (24), and Leming (28).

220 See Letter from Specialist Association (19).

orders.[221] Many commenters believed that, to obtain priority, market participants should be required to improve on a quoted price by at least a penny.[222] Another commenter noted that it had performed an analysis on the manner in which sub-penny quoting and trading was used and found that sub-penny quoting and trading was used primarily to step ahead of resting limit orders and undermine the NASD's Manning Interpretation.[223] As a result, in April 2003 that commenter discontinued all clients' ability to enter orders in Nasdaq securities beyond two decimal places, reasoning that virtually no benefit is derived from the quotations and executions on a sub-penny basis.

Another commenter, however, argued that finer increments would make priority jumping more transparent and more efficient.[224] An additional commenter disputed the theory that sub-penny increments would reduce transparency (i.e., the ability to gauge trading interest at a particular price) by discouraging the use of limit orders, as some commenters contended, noting that its volume and the number of limit orders it receives substantially increased after the

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221 See Letter from ICI (20). The ICI noted that there has already been a reduction in the use of limit orders by institutional investors on the exchanges and Nasdaq under decimalization, citing the SRO decimal studies in support. ICI stated that permitting the entry of orders and the quoting of securities in sub-pennies would allow a trader to gain priority over another trader by bidding as little as $.001 more for the same security with almost no risk of loss.

222 See Letters from NYSE (13), Phlx (22), Rock Island (15), Specialist Association (19), ICI (20), and SIA (21).

223 See Letter from Ameritrade (33). See Section V.D.2.d. infra for a discussion of the Manning Interpretation.

224 See Letter from Levine (26). The commenter noted that when constrained by artificially large increments, market participants tend to enter into private priority jumping arrangements where the incentive payments are typically not included in the price of the executed orders and thus are hidden from the marketplace. The commenter believed that in efficient markets, competitive forces quickly find an equilibrium that thwarts "parasitic pricing," because "parasites" must compete with one another and ultimately must add information to the marketplace to survive.

introduction of decimal pricing, despite the fact that it allows orders to be entered up to three decimal places.[225]

4. Short Sale Regulation

The Concept Release also solicited comment on how a reduction in the minimum pricing increment might impact other price-dependent rules, such as those regulating short sales--the "tick test" of Rule 10a-1 under the Exchange Act[226] and the "bid test" of NASD Rule 3350.[227] The majority of commenters who addressed short sale regulation believed that the rapid trades and flickering quotes that could result if sub-penny pricing were permitted could make compliance with the bid and tick tests more difficult.[228] They noted that, even using automated

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225 See Letter from Island (29). Island further argued that it was not even necessary to outbid another market participant to take priority. For example, a market participant could post the highest bid on the NYSE, yet see numerous transactions occur on regional exchanges without receiving an execution, suggesting that trading ahead can currently occur at the same price as a limit order. Island argued that if trading ahead can occur at the same price, the minimum increment becomes irrelevant in terms of discouraging limit orders.

226 17 CFR 240.10a-1. The current tick test of Rule 10a-1 under the Exchange Act provides that, subject to certain exceptions, an exchange-listed security may be sold short only: (1) at a price above the immediately preceding reported price (plus tick), or (2) at the last sale price if it is higher than the last different reported price (zero-plus tick).

227 The "bid test" of NASD Rule 3350 prohibits NASD members from effecting short sales in Nasdaq NMS securities at or below the best bid when the best bid displayed is below the preceding best bid in a security. If there is an "upbid" in a security, i.e., the best bid displayed is above the preceding best bid, there is no restriction on the price that an NASD member can sell an NMS security short. In November 2003, the Commission proposed a new short sale regulation (Regulation SHO) that would, among other things, provide a uniform short sale price test for exchange-listed and Nasdaq securities, wherever traded. The regulation would restrict all short sales to a price at least a penny above the consolidated best bid. Securities Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972 (Nov. 6, 2003) at Part IV. In the release proposing Regulation SHO, the Commission noted that the proposed bid test should offer more short selling opportunities than the current tick test.

228 See Letters from Momentum/ETA (8), Advanced Clearing (11), NYSE (13), Giannone (16), SIA (21), Phlx (22), BSE (24), and Knight (27).

compliance systems, it would be difficult for traders to effect short sales in volatile markets, and that this would be nearly impossible for human traders in some instances.

5. Quote Rounding

The Concept Release also sought comment on possible scenarios for incorporating sub-penny quotes into the publicly disseminated quote stream. In particular, the Commission sought comment on whether sub-penny quotes should be accepted and rounded to the nearest penny prior to display, or whether the sub-penny quotes should be reflected in publicly disseminated quotes.[229]

Some commenters argued that quoting in sub-pennies should not be allowed, either directly or through a rounding scenario because quoting in sub-pennies would unnecessarily complicate administration of the Order Handling Rules.[230]

In addition, NYSE believed that rounding sub-penny prices to the nearest penny would distort market information. Phlx believed that rounding quotes would increase trade-throughs and locked markets and create uncertainty among investors as to the quality of their executions. It also thought that a rounding indicator attached to the quote would not alleviate these problems.

One commenter argued that, while the Commission should not permit the display of sub-penny increments, mandatory rounding should provide for greater depth at the inside, thus leading to higher transparency, which in turn would have a positive impact on overall execution

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229 In seeking comment on these scenarios, the Commission stated its desire to reexamine no-action relief the staff had granted that permitted market participants to round quotes in increments below the minimum quoting increment without including an indicator identifying these quotes as having been rounded. See supra note 188.

230 See Letters from: NYSE (13), ICI (20), Phlx (22), and Knight (27). On August 28, 1997, the Commission adopted Rule 11Ac1-4 and amendments to Rule 11Ac1-1 under the Exchange Act. See Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) (collectively referred to as the Order Handling Rules).

quality.[231] This commenter believed that, without specific guidelines, each system would round differently, thus making comparison more difficult.[232]

6. Automated Systems

Finally, the Concept Release requested comment on the potential effects that quoting, trading, and reporting securities in increments less than a penny would have on systems capacity. Although a few commenters cautioned that introducing sub-penny trading could have adverse technological impacts on the markets and market participants,[233] many acknowledged that some of the changes needed to facilitate sub-penny trading had already been accomplished with the switch to decimals. Notably, participants in an SIA survey indicated that, during the decimals conversion, most market participants had made adjustments to their automated systems and capacity that could accommodate sub-pennies.[234]

The general consensus of the firms that responded to the SIA survey was that, while redesigning systems and adding capacity to accommodate sub-pennies is technologically feasible, it would require considerable funds and staff time without providing any real benefit to investors or contributing to market efficiency.

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231 See Letter from Advanced Clearing (11). The commenter noted its belief that most orders submitted in sub-penny increments are not rounded by market destinations, and thus transparency in the market is reduced by the non-display of these orders. Furthermore, some ECNs display out to three decimal places and will not accept orders to four decimal places.

232 Id.

233 See Letters from STA/ECN (14), SIA (21), BSE (24), and Knight (27).

234 See Letter from SIA (21). To address the Commission's questions relating to automated systems, the SIA conducted an informal survey of member firms, SROs, clearing organizations, and vendors to determine the industry's readiness to trade and quote securities in sub-pennies.

Vendors that responded to the SIA survey reported that their display capabilities varied, with four decimal places being a common constraint, although some were limited to two or three decimal places. Capacity was also viewed as an important concern.

Some SROs that responded to the SIA survey indicated that they would need to expand capacity to accommodate sub-penny trading. Others stated that they were not yet ready to handle multiple decimal places, and that moving beyond two decimal places would require major systems redesign.

An ECN countered arguments that moving to sub-pennies would have a detrimental effect on automated systems, stating it had not experienced any capacity problems, even though 40% of its displayed orders were in sub-pennies. That ECN believed that the continual increases in processing power and bandwidth would alleviate any capacity concerns and that any decision on sub-pennies should not be based on the system limitations of some industry participants.[235]

D. Nasdaq's Rule Proposal and Petition for Commission Action

1. Proposed Rule Change

On August 5, 2003, Nasdaq filed a proposed rule change that would permit it to adopt a minimum quotation increment of $0.001 for Nasdaq-listed securities.[236] The current minimum quotation increment for those securities is $0.01.[237] In the proposal, Nasdaq states that the existing environment, in which market participants use quote increments ranging from pennies to hundredths of pennies, harms investors by creating a two-tiered market, one for ordinary investors (who may not have access to sub-penny quotes) and another for professionals (who do

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235 See letter from Island (29).

236 File No. SR-NASD-2003-121.

237 NASD Rule 4613(a)(1)(B).

have access). Nasdaq argues that, unless and until a uniform quote increment is established, it must implement a minimum quote increment of $0.001 to remain competitive with ECNs that permit their subscribers to quote in sub-pennies.

2. Petition for Commission Action

Simultaneous with the proposed rule change, Nasdaq filed a petition for Commission action requesting that the Commission adopt a uniform rule requiring market participants to quote and trade Nasdaq-listed securities in a "consistent monetary increment," with the exception of average-priced trades.[238] According to Nasdaq, sub-penny trades represented about 5% of all trades and shares executed on or reported to Nasdaq between 1999 and 2001, but had increased to 16% in the prior year. Nasdaq believes this increase was caused by sophisticated order routing systems that are calibrated to sub-penny increments. Nasdaq states that these systems gather quotes from SROs and ECNs, rank those quotes in increments as small as 1/100th of a cent, and route orders to the best available quotations based upon those rankings. Nasdaq contends that these systems are a principal reason why market makers, ECNs, and other market participants have begun accepting limit orders and displaying quotations in sub-pennies.

a. Two-Tiered Market

In Nasdaq's view, sub-penny quotes disadvantage ordinary investors because such quotes are not reflected in the NBBO data that is disseminated to the public. Moreover, according to Nasdaq, most traditional and electronic brokerage firms that serve retail investors limit their clients to placing orders in whole penny increments.[239] As a result, Nasdaq asserts that smaller

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238 See Letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, Commission (August 4, 2003) ("Nasdaq Petition").

239 According to Nasdaq, online brokerages like Ameritrade, TD Waterhouse, Schwab, and E*Trade accept customer orders only in penny increments, whereas direct access firms

investors generally can neither see nor access sub-penny quotes, thereby creating a two-tiered market, one for professional traders and one for average investors.

b. Disparate Quoting and Trading Conventions

Nasdaq further contends that there is a great disparity in quoting and trading conventions among market participants and that these differences, which are not widely known, can disadvantage investors who generally would not be aware of the many differences in the practices for receiving and disseminating quote and trade information. Nasdaq states the following:

- Ordinary investors often are limited to submitting orders in penny increments largely because many prominent online brokerages only accept orders in pennies.
- ECNs and Nasdaq market makers accept and execute orders in sub-penny increments.
- Some ECNs display and execute orders out to three decimal places, and some do so only for stocks priced below $10 per share. Other ECNs accept and execute orders out to four decimal places.
- Market makers generally quote only in penny increments but often offer price improvement to customer orders in sub-penny increments.
- Nasdaq, as a market center, accepts quotes in penny increments and orders in sub-penny increments up to four decimal places, but Nasdaq states that it truncates (or cuts off) the prices of those orders to two decimal places and does not rank or display orders based on

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that cater to day traders and hedge funds typically accept orders in sub-penny increments. Id. at p. 4. According to Ameritrade, beginning with the start of decimalization in April 2001, Ameritrade allowed its clients to place orders up to four decimal places on Nasdaq-listed securities but discontinued this practice in April 2003 after determining that its clients were "primarily utilizing sub-penny quoting and trading to step ahead of resting limit orders and undermine the [NASD's] Manning provision." See Letter from Ameritrade (33).

sub-pennies. While SuperMontage does not execute or display quotes and orders in sub-pennies, firms that accept orders delivered in penny increments (as opposed to those that accept automatic executions) can respond to those orders by offering sub-penny price improvement. Nasdaq's Automated Confirmation Transaction ("ACT") service accepts trade reports from Nasdaq market participants out to six decimal places.

- Archipelago Exchange (a facility of the Pacific Exchange) truncates orders it receives in sub-pennies and executes in pennies. Other exchanges (which Nasdaq does not name) that trade Nasdaq-listed securities display quotes in penny increments but allow trade reporting in sub-penny increments.
- The exclusive securities information processors (SIPS--Nasdaq for Nasdaq securities and SIAC for exchange-listed securities) disseminate quotes in penny increments, which means that no sub-penny quotes are displayed to the public.
- All major market data vendors, including Reuters, Bloomberg, and ILX, provide quotation data in penny increments.
- Order matching systems such as ITG's POSIT, use sub-penny increments to match customer orders at the midpoint of the bid and ask quotation in stocks with a penny spread and report average-priced trades.[240]
- Order management systems, such as LAVA and Sungard's PowerNet, rank and display quotes and orders in increments up to four decimal places.

c. Stepping Ahead of Limit Orders

[240] See ITG's web site for a further description of POSIT (http://www.itginc.com/products/posit/).

Nasdaq also contends that some market participants use sub-pennies to "step-ahead" of displayed quotes and limit orders for an economically insignificant amount, thereby devaluing price priority and reducing the incentive for aggressive quoting. Nasdaq provides an example where the national best bid in Microsoft is 25.12. A trader enters an order to buy 100 shares at 25.121 (Order A) and a second trader then enters an order for 100 shares at 25.1211 (Order B). An order routing system that ranks orders in sub-pennies would give execution priority to Order B. Even though the total value of the trade was $2512.11, Order B would gain execution priority over the best bid for 11 cents and over Order A for only one cent.

Nasdaq states that its internal research on sub-penny pricing supports the conclusion that market participants are deliberately using sub-pennies to gain priority over orders rather than to contribute to legitimate price discovery. Nasdaq states that in March 2003 it analyzed sub-penny pricing behavior and determined that 37 % of sub-penny prices at the third decimal place (i.e., $0.001) occur at the $0.001 or $0.009 price points and that 43 % of sub-penny prices at the fourth decimal place occur at the $0.0001 or $0.0009 price points. Nasdaq concludes that these numbers are statistically significant indicators that market participants use sub-penny prices to gain priority over other orders for the smallest amount possible.

d. Potential Impact on Regulatory Requirements

Nasdaq also contends that sub-penny pricing can complicate compliance with various regulatory requirements, including marketplace customer protection rules, such as the NASD's Manning Interpretation, broker-dealer best execution obligations, and short sale restrictions.

According to Nasdaq, NASD IM-2110-2, the so-called Manning Interpretation, is designed to ensure that broker-dealers protect their customer limit orders by requiring NASD member firms to provide a minimum level of price improvement to incoming orders in Nasdaq-

listed securities if the firm chooses to trade as principal with those incoming orders at prices superior to customer limit orders they currently hold. If the firm fails to provide the minimum level of price improvement to the incoming order, it must execute its customer limit orders or it is in violation of Manning. Nasdaq is currently operating a pilot relative to its Manning Interpretation that could be impacted in a sub-penny environment.[241] The Manning pilot requires that before a Nasdaq market maker may interact as principal with (i.e., internalize) an incoming order, it must provide price improvement to the incoming order of at least $0.01 above any customer limit orders that the market maker is holding if any of those limit orders are priced at, or better than, the best market displayed in Nasdaq. If the customer limit orders are priced outside the best market displayed in Nasdaq, the Nasdaq market maker must price improve an incoming order by the next superior minimum quotation increment permitted by Nasdaq. Therefore, if Nasdaq were to change its minimum quoting increment to $0.001 as it has proposed, market makers would be permitted to step ahead of certain limit orders for $0.001. Nasdaq contends that a sub-penny price improvement standard with respect to Manning would not adequately protect investors.

Nasdaq also believes that sub-penny pricing makes it more difficult for broker-dealers to comply with their best execution obligation.[242] Nasdaq contends that in the absence of uniform

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[241] See Securities Exchange Act Release No. 48876 (Dec. 4, 2003), 68 FR 69103 (Dec. 11, 2003) (notice of filing and immediate effectiveness of SR-NASD-2003-180). Unless extended or approved permanently, the Manning pilot would expire on June 30, 2004. If the pilot were to expire, the terms of the Manning Interpretation that were in effect prior to the pilot would apply. Under such terms, market makers would, in certain limited circumstances (i.e., where the spread is one cent), be permitted to price improve by one-half cent without triggering Manning obligations. See NASD Notice to Members 97-57. In addition to Manning, a broker-dealer has a best execution obligation with respect to its handling of customer orders.

[242] Generally, that duty requires broker-dealers to seek the most favorable terms reasonably available under the circumstances for a customer's transaction.

quoting and trading increments, it is difficult for broker-dealers to conduct the necessary "regular and rigorous" assessment to determine whether they are meeting their best execution obligations. Moreover, Nasdaq believes that decimalization generally and sub-penny pricing in particular likely increases the frequency of price changes (so-called "flickering quotes"), thereby making it more difficult for a broker-dealer to determine whether a particular price is "reasonably available," a key component in the best execution assessment.

Nasdaq further contends that flickering quotes could complicate the administration of NASD Rule 3350, which restricts short selling.[243] Nasdaq states that this rule relies on the most recent bid change to assess whether a particular short sale is legal. Nasdaq contends that sub-penny quoting will render NASD's rule "unmanageable."

Finally, Nasdaq contends that a move to sub-penny pricing will further reduce market liquidity and depth without any economically meaningful offsetting reduction in quoted and effective spreads and will increase market participants' costs.

E. SEC Staff Research on Sub-Pennies

The Commission's Office of Economic Analysis (OEA) conducted research on sub-penny trading and found clustering activity similar to that which Nasdaq discusses in its petition for Commission action.[244] OEA conducted a study of sub-penny trading for the week of April 21-25, 2003, and found:

- Sub-penny trades accounted for 12.9% of trades in Nasdaq-listed issues, 9.8% of trades in Amex-listed issues, and 1.0% of trades in NYSE-listed issues in the sample week.[245]

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243 See supra note 227 for a further description of the operation of NASD Rule 3350.

244 This study can be accessed in the Commission's public reference room.

245 The average size of sub-penny trades was 553 shares for Nasdaq-listed securities (compared to 607 shares for trades in pennies), 1,898 shares in NYSE-listed securities

Trades in ETFs that were reported as CSE or Nasdaq executions accounted for the majority of Amex sub-penny trades. Over 40% of all trades in Nasdaq issues reported to CSE (where Island ECN is the dominant player) were in sub-pennies. Most sub-penny trades in NYSE-listed issues were also reported as Nasdaq trades.[246]

- Sub-penny trades cluster at $0.001 (1/10th cent) and $0.009 (9/10th cent) price points. In Nasdaq issues, 25.1% of sub-penny trades executed at a $0.001 price point and 24.3% of sub-penny trades executed at a $0.009 price point, for a combined total of 49.4%. Trades on other tenth-cent sub-penny price points (e.g., those on a price point of $0.004) each accounted for only 5% -7% of sub-penny trades. In contrast, the expected price pattern is uniform increment usage, or clustering on mid-point prices (i.e., $0.005) and larger increments. This uniform increment usage pattern is found in penny usage where clustering occurs on dime and nickel multiples. The sub-penny pattern of clustering on the $0.001 and $0.009 price points is consistent with the use of sub-penny pricing to gain priority over existing quotes or limit orders.[247]
- Another 12% of sub-penny trades occurred at a price increment of $0.0001 (1/100th cent), and about one-half of these trades occurred at the most extreme price points of $0.0001 or $0.0009.

(compared to 1,117 shares for trades in pennies), and 1,314 shares in Amex-listed securities (compared to 1,970 shares for trades in pennies).

246 Because sub-penny trading occurs on ECNs, the resulting executions appear as trade reports on CSE (now NSX), Nasdaq, and NASD's ADF where ECNs report trades.

247 For example, if the spread in a stock were $10.00 (bid) - $10.01 (offer), a market participant would step ahead of the best bid by bidding $10.001, and step ahead of the best offer by offering $10.009.

- Overall frequency of sub-penny trades and the level of sub-penny clustering is approximately the same at all price levels. For example, 10.5% of trades in securities priced below $1.00 were executed in sub-penny increments compared to 11.5% of trades in securities priced greater than $60. The fraction of sub-penny trades executed at the $0.001 and $0.009 price points was close to 50% for all price levels. These results suggest that sub-penny prices are generated by proprietary trading algorithms.
- Sub-penny trades occur more frequently for actively traded stocks. In the 20 most active Nasdaq stocks (measured by share volume), 22.1% of trades were executed in sub-pennies and sub-penny trades occur less frequently as trading activity declines. Sub-penny clustering on 1s and 9s occur at each trade activity level.

OEA observed that earlier studies suggest that traders tend to use minor price points more often for lower priced securities.[248] OEA concluded that the absence of this relation in the current study suggests that the use of sub-penny pricing for most stocks is more likely related to traders' attempts to gain precedence over competing orders than to legitimate price discovery.

F. Discussion of Proposed Rule

Generally, the Commission believes that competitive forces in the marketplace should determine the prices that market participants may bid or offer for securities. As such, the Commission acknowledges the arguments of the commenters discussed above in response to the Concept Release that, in the absence of a compelling public policy interest, market forces rather than the government should determine the manner in which securities are priced. At the same time, however, in Section 11A of the Exchange Act Congress directed the Commission to

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[248] See, e.g., Harris, Larry, "Stock Price Clustering and Discreteness," Review of Financial Studies (1991).

facilitate the development of a national market system for securities. In January 2000, the Commission determined that the markets' conversion to decimal pricing was consistent with its obligations under Section 11A because the Commission believed that decimal pricing could benefit investors by "enhancing investor comprehension, facilitating globalization of our markets, and potentially reducing transactions costs, depending on the minimum price variant used."[249] For the most part, that minimum price variant has meant penny pricing.

As discussed above, the implementation of decimals has met the goals the Commission had in ordering it. Decimal pricing is now an accepted component of the U.S. securities markets. Spreads in equity securities are far lower than they were under the outmoded, fraction-based pricing system, thus resulting in reduced trading costs for investors entering orders that are executed at or within the quotes.

In the Commission's view, however, the marginal benefits of a further reduction in the minimum pricing increment are not likely to justify the costs to be incurred by such a move. Indeed, the Commission believes that the markets' experience with sub-penny quoting indicates that the practice, if allowed to persist, could actually harm investors and the markets.

The Commission believes that OEA's research discussed above strongly suggests that much of the trading that currently takes place in sub-pennies is the result of market participants attempting to step ahead of penny-priced limit orders for the smallest economic increment possible. In the Commission's view, it is unlikely that the high rate of sub-penny clustering around $0.001 and $0.009 price points would have occurred in the absence of stepping ahead behavior. Furthermore, as OEA's research suggests, some sub-penny pricing as well as clustering around the 1 and 9 price points also occurred in increments finer than $0.001, which

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[249] Securities Exchange Act Release No. 42360, 65 FR at 5005.

suggests that sub-penny pricing and the resulting stepping ahead activity could be taken to an absurd extreme.[250] When market participants can gain execution priority for an infinitesimally small amount, important customer protection rules such as exchange priority rules and the NASD's Manning Interpretation as currently formulated could be rendered meaningless. Without those protections, professional traders would have more opportunities to take advantage of non-professionals, which could result in the non-professionals either losing executions or receiving executions at inferior prices. If investors' limit orders lose execution priority for a nominal amount, over time, investors may cease to use them, which would deprive the markets of a vital source of liquidity. Therefore, the use of sub-penny pricing could harm investors and the markets.

Moreover, the Commission believes that the increase in flickering quotes that could result from widespread sub-penny pricing could make it more difficult for broker-dealers to satisfy their best execution obligations and other regulatory responsibilities. The best execution obligation requires broker-dealers to seek for their customers' transactions the most favorable terms reasonably available under the circumstances.[251] This standard is premised on the practical ability of a broker-dealer to determine whether a displayed price is or is not reasonably obtainable given the technology available to that broker-dealer. The Commission is concerned that a trend toward widespread sub-penny quoting could make it a practical impossibility for brokers to determine with reasonable certainty whether displayed prices are likely to be available.

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250 As noted above, the average sizes for sub-penny trades and penny trades are comparable. See supra note 245.

251 See Securities Exchange Act Release No. 37619A, 61 FR at 48322.

The same rationale would also apply with respect to compliance with short selling restrictions. Under a bid test as the Commission has proposed in Regulation SHO and which is the prevailing standard for Nasdaq-listed securities, market participants must be able to determine what was the last prevailing bid to determine whether they may effect a short sale. The more rapidly the quote changes, the more difficult it becomes to make that determination.

Furthermore, the Commission believes that widespread sub-penny quoting could exacerbate a number of the disadvantageous aspects of decimal pricing. For example, sub-penny pricing could decrease depth (i.e., the number of shares) available at the best displayed prices. OEA's research indicates that some market participants already are quoting in pricing increments as narrow as $0.0001. Experience with decimal pricing generally would seem to suggest that further decreases in the quoting increment could lead to further declines in the number of shares available at a given price.[252] Finer slices of liquidity at any given price could lead to higher transaction costs, particularly for institutional investors (such as pension funds and mutual funds) which are more likely to place large orders. These higher transaction costs would likely be passed on to retail investors and others that have assets in funds managed by the institutions. Decreasing depth at the inside could also cause such institutions to rely more on execution alternatives away from the exchanges and Nasdaq, which are designed to help larger investors find matches for large blocks of securities. Such a trend could further fragment the securities markets.

Although sub-penny pricing currently appears, for the most part, to be limited to trading in Nasdaq-listed securities through ECNs and ATSs, Nasdaq's rule proposal, discussed above,

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[252] As discussed above, both Nasdaq and NYSE found that depth at the inside price declined substantially with the implementation of decimals. See supra notes 200 - 202 and accompanying text.

effectively would extend sub-penny trading to all securities that are traded through Nasdaq systems, which would include all Nasdaq securities and presumably exchange-listed securities that are traded by Nasdaq market participants pursuant to unlisted trading privileges.[253]

As Nasdaq states in its petition for Commission action, there currently is no industry standard for trading and quoting increments. Although Nasdaq and the exchanges currently permit quoting in single penny increments, these markets allow trades to be printed in increments below a penny. Although certain online brokers only accept orders priced in one-cent increments,[254] ECNs and Nasdaq market makers accept orders and execute trades in sub-penny increments.[255] While market makers quote through Nasdaq only in penny increments, they may display orders in ECNs in sub-pennies. This lack of uniformity in pricing is not only confusing but it also increases the likelihood that more sophisticated market participants will use the discrepancy in pricing increments as an arbitrage opportunity that is unlikely to be available to less informed investors.[256]

To address the concerns discussed above, the Commission is proposing a rule that would prohibit every national securities exchange, national securities association, ATS (including

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253 OEA found that Nasdaq market participants currently report trades in NYSE-listed securities in sub-penny increments. If sub-penny quotes were permitted through SuperMontage, Nasdaq's primary trading system, trading in those securities in sub-pennies could ramp up quickly.

254 See, e.g., Letter from Ameritrade (33).

255 See Nasdaq Petition, supra note 238.

256 For example, sophisticated market participants with access to those trading venues that permit sub-penny pricing may buy or sell securities at prices that are a fraction of a cent better than would be available through Nasdaq or an exchange that only permits penny pricing. They could then unwind those transactions through Nasdaq or an exchange and make a risk-free profit.

ECNs), vendor, broker or dealer from ranking, displaying, or accepting from any person a bid or offer, an order, or an indication of interest in any NMS stock in an increment less than $0.01.[257]

The proposed rule would exclude NMS stocks with a share price below $1.00. The Commission excluded low-priced securities from the proposed rule because a sub-penny increment represents a greater percentage of the value of a given share of such securities than it does for higher-priced securities. [258] Below, the Commission seeks comment on whether such an exclusion is desirable, and if so, whether $1.00 per share is the correct measure for low-priced securities.

The proposed rule is intended to prohibit the acceptance, display, or ranking of trading interest in an NMS stock (other than a low-priced security) in an increment below one cent. For example, the rule would prohibit a market maker or specialist from accepting a customer limit order priced in an increment below one cent. It would also prevent the market maker or specialist from displaying its proprietary quote in an increment below a penny whether through any exchange, Nasdaq, ADF, or through an ECN or a vendor.

In addition, the proposed rule would prohibit market participants from ranking orders, quotes, or indications of interest in an NMS stock (other than a low-priced security) that are

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[257] An indication of interest is a non-firm expression of interest to trade at a given price. Although the proposed rule would not apply to options, in the solicitation of comment section below, the Commission seeks comment on whether the proposal should be expanded to apply to options.

[258] The Commission also believes that the $1.00 threshold is an attractive cut-off point for the sub-penny pricing proposal because it is also the level at which SROs begin delisting procedures against issuers, which can coincide with a reduction in trading volume, thereby reducing the economic incentives to quote in sub-pennies. See, e.g., NASD Rule 4310(c)(4) (delisting standards for SmallCap securities) and NASD Rule 4450(a)(5) and (b)(4) (delisting standards for Nasdaq NMS securities). The proposed rule provides that the Commission can grant exemptions from the sub-penny quoting prohibition consistent with Section 36 of the Act. 15 USC 78mm.

priced in an increment less than a penny. In other words, the rule is intended to ensure that a market participant can only receive execution priority over standing limit orders or quotes by improving the best displayed price by more than a nominal amount (i.e., by at least a penny per share).[259]

The proposed rule is intended to address the concern that the non-uniform display of sub-penny quotes is creating hidden markets whereby more sophisticated traders can view and access better prices than those available to the general public. The proposal also could mitigate a disincentive to using limit orders (i.e., the prospect that a market participant can gain execution priority by bettering the limit price by an economically insignificant amount).

The proposed rule would not prohibit an exchange or association from reporting or "printing" a trade in a sub-penny increment, as most markets currently permit. Therefore, a broker-dealer could, consistent with the proposed rule, provide price improvement to a customer order in an amount that resulted in an execution in an increment below a penny so long as the broker-dealer did not accept orders that already were priced in increments below a penny.[260]

In addition, the proposed rule would not per se prohibit an exchange or association from printing a trade that was the result of a mid-point or volume-weighted pricing algorithm, as long as the exchange or association or its members did not otherwise violate the proposed rule with respect to the trading interest that resulted in the execution. For example, a system that accepted unpriced orders that were then matched at the midpoint of the NBBO would not violate the

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[259] The proposed rule would supplement other protections in place to protect customer limit orders, such as NASD's Manning Interpretation and broker-dealers' best execution obligation.

[260] Such price improvement would also need to be done in a manner that was consistent with the broker-dealer's obligations under other Commission and SRO rules (e.g., best execution and Manning).

proposed rule even though resulting executions could occur in share prices of less than one cent. If such a system were operated by an association, exchange, ATS, or broker-dealer, however, and the system accepted orders priced in sub-penny increments and those orders matched against one another in the system, the system operator would have violated the proposed rule by accepting and (possibly) ranking orders in prices below a penny.

The Commission is not proposing to prohibit trading in sub-pennies because it does not believe at this time that trading in sub-penny increments raises the same concerns that sub-penny quoting does. The Commission seeks comments, however, on this and other issues below.

G. General Request for Comment

Question 1. What are the costs and benefits of a prohibition against quoting in increments finer than a penny? Do the benefits of a prohibition justify the costs?

Question 2. Nasdaq in its petition for Commission action and commenters in their responses to the Commission's sub-penny Concept Release identified a number of concerns with sub-penny pricing (e.g., creation of hidden markets, loss of depth and liquidity, and increases in flickering quotes). Have Nasdaq and the commenters that opposed sub-penny pricing accurately stated the likely impact of sub-penny pricing? Are there other concerns with sub-penny pricing that were not mentioned by Nasdaq or the commenters to the Concept Release? If these concerns are warranted, do they justify the prohibition of sub-penny quoting that the Commission has proposed?

In its petition for Commission action, Nasdaq asks the Commission to adopt a rule requiring market participants to quote and trade Nasdaq securities in a consistent monetary increment or MPV. In one respect, the rule that the Commission is proposing would be broader than that requested by Nasdaq in that it would apply to Nasdaq-listed as well as exchange-listed

securities. In another respect, however, the Commission's proposal is narrower than Nasdaq's request, in that it would prohibit sub-penny quoting but not trading.

Question 3. What are the advantages and disadvantages of the Commission's proposal versus the rulemaking that Nasdaq proposes? For example, which proposal would be the most likely to address the concerns raised by sub-penny pricing in the most efficient manner? For commenters who believe that sub-pennies raise concerns that should be addressed with regulatory action, are those concerns limited to Nasdaq-listed securities or do they apply to exchange-listed securities also?

Question 4. The Commission's proposal would apply to Nasdaq-listed and exchange-listed securities alike. Are there differences in those types of securities that might warrant different treatment with respect to sub-penny pricing? If so, what are they?

Question 5. Would the rule that the Commission has proposed address the primary concerns that have been raised about sub-penny pricing? If not, are there other steps the Commission should take in addition to (or instead of) the proposed rule to address those concerns?

Question 6. The rule that the Commission has proposed would not prohibit, under certain circumstances, trades to be executed in sub-penny increments (i.e., those resulting from sub-penny price improvement or from mid-point or volume-weighted pricing systems). Should the scope of the rule be expanded to prohibit this type of sub-penny pricing also? If the current rule is approved as proposed, what means would the Commission and responsible SROs need to have in place to discern which sub-penny trades are the result of permissible trading activity and which are not? Are these means currently in place or would new procedures and systems need to be implemented?

Question 7. The rule that the Commission has proposed excludes securities priced below $1.00 per share. Does sub-penny pricing in low-priced securities raise the same concerns that have been raised about such pricing generally? If so, are there other reasons why low-priced securities should nevertheless be excluded from the proposed rule? If commenters believe that low-priced securities should be excluded from the proposed rule, is $1.00 per share an appropriate price level for such an exclusion? Would $2.00 per share be more appropriate? If not, what is an appropriate price level—higher or lower than $1.00? If low-priced securities are properly excluded from the proposed rule, should the exclusion apply as soon as a security drops below $1.00 per share or should the proposed rule require that the securities trade below that level for a certain period of time (e.g., for 10 trading days)? How would investors and other market participants know whether or not a security had met the required test?

Question 8. The proposal currently does not apply to options. Should the Commission extend the proposal to options? Are there differences between options and NMS stocks (to which the proposal currently applies) that would make a prohibition such as the one the Commission is proposing undesirable or infeasible for options? If so, what are these differences?

Question 9. Are there other types of securities that should be excluded from the proposed rule? For example, do ETFs, which are derivatively priced, raise the same concerns that have been expressed with respect to sub-penny pricing generally? If not, should ETFs be excluded from the proposed rule?

Finally, the Commission seeks general comment on the proposal described in this Release as well as Nasdaq's petition for Commission action. In addition to the specific requests for comment included above, the Commission asks commenters to address whether the proposed

rule and petition for Commission action would further the national market system goals set out in Section 11A of the Exchange Act. The Commission also requests comment on whether, if it were to adopt the proposed Commission rule, a phase-in period would be necessary or appropriate to allow market participants time to adapt to it. If so, what would be an appropriate phase-in period? The Commission also invites commenters to provide views and data as to the costs and benefits associated with the proposed rule and petition for Commission action. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[261] the Commission also is requesting information regarding the potential impact of the proposed rule on the economy on an annual basis. If possible, commenters should provide empirical data to support their views.

H. Paperwork Reduction Act

The Commission does not believe that proposed Rule 612 under the Exchange Act contains any collection of information requirements as defined by the Paperwork Reduction Act of 1995, as amended, but the Commission encourages comments on this point.[262]

I. Consideration of Costs and Benefits

Under proposed Rule 612 market participants would be prohibited from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment finer than a penny in NMS stocks, other than those with a share price below $1.00. The Commission has identified the benefits and costs as described below and encourages commenters to identify, discuss, analyze, and supply relevant data regarding any additional costs or benefits. Specifically, the Commission requests data to quantify each of the costs and the value of each of

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[261] Pub. L. No. 104-121, 110 Stat. 857.

[262] 44 USC 3501 et seq.

the benefits identified. The Commission also seeks estimates and views regarding each of the identified costs and benefits of the proposal for particular types of market participants and any other costs or benefits that may result from the adoption of the proposed rule.

1. Benefits

In carrying out its oversight of the national market system, the Commission seeks to serve the interest of investors by adopting rules designed to ensure that securities transactions can be executed efficiently, at prices established by vigorous and fair competition among market centers. The Commission believes that the markets' conversion to decimal pricing has benefited investors by, among other things, clarifying and simplifying pricing for investors, making our markets more competitive internationally, and reducing trading costs by narrowing spreads. The Commission is concerned, however, that if the MPV decreases beyond a certain point, some of the benefits of decimals could be sacrificed. At the same time, some of the negative impacts associated with the decimal conversion could be exacerbated. The proposed rule restricting the use of sub-pennies could bring numerous benefits, as discussed below. The Commission requests comments on the benefits identified below and any benefits of the proposal we may not have identified.

a. Preserve Price Clarity

The conversion to decimals clarified pricing for investors by allowing them to compare securities in dollars and cents rather than fractions. Quotations in sub-pennies, however, have the potential to undercut price clarity by forcing market participants to choose quickly between slightly different and rapidly changing

prices that could be located in different markets. Prohibiting sub-penny quoting could reduce the incidence of such flickering quotes which can impair broker-dealers' efforts to fulfill their best execution obligations by making it harder to determine whether particular prices are reasonably available.

b. Enhance Market Transparency

Market transparency, the dissemination of meaningful quote and trade information, assists investors in making informed order entry decisions and enhances broker-dealers' ability to meet their best execution duties. The Commission has been particularly concerned about the development of so-called "hidden markets," in which more sophisticated traders can view and access quotations in sub-pennies at prices superior to the quotation information available to the general public. The Commission's proposal could enhance transparency by mandating that NMS stocks trade in prices displayed and readily accessible to the general public. In doing so, the proposed rule could help to eliminate the current two-tiered structure, one for professional traders and one for average investors.

c. Enhance Market Depth

For investors and other market participants to make use of the price information provided by the consolidated quotation systems, there needs to be meaningful information available concerning depth, the amount of buy and sell interest available at any given price. As the MPV is reduced, the depth available for any given security may become disseminated over more price points. In addition, smaller increments may increase the risk for investors placing limit orders, particularly large limit orders, by allowing one market participant to gain priority over the limit order without making an economically significant contribution to the price of the security. This could in turn have a negative impact on depth, as traders become reluctant to post limit orders. A

resultant impact could be increased transaction costs associated with executing orders, particularly large orders. The Commission's proposal could benefit investors by helping, in conjunction with other rules designed to protect customer limit orders, to ensure that a market participant can only receive execution priority over standing limit orders or quotes by improving the best displayed price by something more than a nominal amount. The proposed rule also could help to mitigate a disincentive to using limit orders (i.e., the prospect that a market participant can gain execution priority by bettering the limit price by an economically insignificant amount) and therefore could benefit the markets by increasing liquidity, depth, and transparency.

2. Costs

The Commission recognizes that there may be costs involved with the proposal. A prohibition against displaying orders, quotes, or indications of interest in sub-pennies by market participants could lead to a removal of better pricing of securities from the market. The restriction on the use of sub-penny quoting could decrease the potential for narrower spreads in markets that might have chosen to permit sub-penny pricing because there would be fewer potential price points. Market participants, particularly subscribers of ECNs that permit sub-penny quoting, could be adversely affected by the proposed rule because the proposal would diminish their ability to gain execution priority over standing limit orders based on smaller quote changes. In other words, under the proposal, an ECN subscriber would be required to improve the best prevailing quote by at least a penny to gain execution priority. The Commission requests comment on each of the potential costs of the proposed rule identified below and any costs not described here. The Commission encourages commenters to provide data to quantify these costs.

a. Pricing

The Commission recognizes that the proposed rule would impose some costs, namely on investors and broker-dealers executing orders either for customers or their proprietary accounts. In particular, restricting the ability of market participants to display, rank, or accept orders in sub-pennies could prevent investors, or broker-dealers executing orders on behalf of investors, from executing their orders at better prices. We believe that currently sub-penny use is limited primarily to professional traders. Going forward, market participants that currently use sub-penny price increments and those that might use them if they were permitted could incur opportunity costs by being precluded from quoting in sub-pennies.

b. Spreads

The bid-ask spread, the difference between what the buyer is willing to pay for the security and the seller's asking price, might not be as narrow as it otherwise could be in those markets that might have decided to permit sub-penny quoting.

c. Business Models

As indicated in the OEA Study, sub-penny quoting currently is most prevalent in Nasdaq-listed securities and in trading of ETFs where ECNs play a more dominant role. As a result, some market participants, specifically ECNs, who have been able to utilize business models that achieve execution priority by improving prevailing prices by a sub-penny increment might be adversely affected by the proposed rule.

d. Automated Systems

The restriction on the use of sub-pennies could have an adverse technological impact on market participants. The Commission recognizes that the proposed rule could require quoting market participants, national securities exchanges, and national securities associations that

currently are capable of accepting and displaying orders in sub-pennies to incur costs by reprogramming their systems to stop these orders from entering.

J. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.[263] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Act, to consider the impact such rules would have on competition.[264] Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission has considered the proposed rule in light of these standards and preliminarily believes that the proposed rule will not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. To the contrary, by preserving the benefits of decimalization, guarding against the less desirable effects of further reducing the MPV, and addressing the growing number of sub-penny quotes that are neither displayed nor readily accessible to the general public, proposed Rule 612 may promote fair and vigorous competition. Although we acknowledge that the proposed rule would, in some circumstances, prevent market participants from offering marginally better prices, the Commission is concerned that sub-penny quoting may be used more as a means for market

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[263] 15 USC 78c(f).

[264] 15 USC 78w(a)(2).

participants to step ahead of competing limit orders for an economically insignificant amount to gain execution priority than as an extrinsic expression of trading interest.

The Commission believes that the proposed rule would assist broker-dealers in evaluating and complying with their best execution obligations, as well as other rules that operate off a minimum increment. The Commission also believes that the proposed rule would enhance depth and transparency by preventing trading interest from being spread across an increasing number of price points. It also would prevent market participants from gaining priority over a standing limit order without making an economically significant contribution to the price of a security. In these respects, the proposed rule would encourage market participants to use limit orders, an important source of liquidity. Accordingly, the proposed rule may promote market efficiency, competition, and capital formation. In addition, the proposed rule would also bolster investor confidence by ensuring that their orders, especially large orders, can be executed without incurring large transaction costs. This increase in investor confidence should also promote market efficiency, competition, and capital formation.

The Commission believes that the proposed rule would establish common quoting conventions that would increase transparency in the markets. Moreover, the Commission believes that the proposed rule would encourage interaction between the markets and reduce fragmentation by removing impediments to the execution of orders between and among markets. The increased transparency in the markets and reduction of fragmentation between the markets may bolster investor confidence, thereby promoting capital formation.

The Commission requests comment on whether the proposed rule would promote efficiency, competition, and capital formation.

K. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[265] we must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- A significant adverse effect on competition, investment, or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed regulation on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

L. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (IRFA), in accordance with the provisions of the Regulatory Flexibility Act (RFA),[266] regarding the proposed Rule 612 under the Exchange Act.

1. Reasons for the Proposed Action

The Commission believes that while the conversion from fractions to decimals benefited investors by clarifying and simplifying pricing for investors, making our markets more competitive internationally, and reducing trading costs by narrowing spreads, these benefits

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265 Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 USC, 15 USC and as a note to 5 USC 601).

266 5 USC 603.

could be sacrificed by decreasing the MPV from a penny to pricing increments finer than a penny. The Commission is particularly concerned that the growing trend in the industry, particularly among ECNs, to display quotations in their proprietary systems in sub-pennies is creating so-called "hidden markets," in which more sophisticated traders can view and access quotations in sub-pennies at prices superior to the quotation information available to the general public. In addition, Nasdaq has recently filed a proposed rule change to permit it to adopt a minimum quotation increment of $0.001 for Nasdaq-listed securities, while simultaneously also filing a petition for Commission action in which it asks the Commission to establish a uniform quoting and trading increment for securities.

The Commission thus believes that this would be an opportune time to address these issues by proposing a uniform standard of quoting in NMS stocks. The Commission is thus proposing to prohibit any vendor, exchange, association, broker-dealer, or ATS (including ECNs) from accepting, ranking, or displaying quotes, orders or indications of interest in NMS stocks in sub-penny increments.

2. Objectives

The proposed rule is designed to fulfill several objectives. Proposed Rule 612 seeks to promote transparency by eliminating what may be resulting in a two-tiered system whereby broker-dealers are able to view quotations in sub-pennies that are not displayed or readily available to the general public. The proposed rule is also designed to prevent widespread quoting in sub-pennies, which could harm the markets and investors, by undermining a number of the benefits of decimalization. In particular, sub-penny quotes could impair broker-dealers' efforts to meet their best execution obligations, and interfere with investors' understanding of securities prices. In addition, the proposed rule is designed to enhance depth by preventing

quotations from being spread across an increasing number of price points, while also encouraging the use of limit orders, an important source of liquidity, by preventing competing market participants from stepping ahead of limit orders for an economically insignificant amount.

3. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 3(b), 5, 6, 11A, 15, 15A, 17(a) and (b), 19, 23(a), and 36 thereof, 15 U.S.C. 78c(b), 78e, 78f, 78k-1, 78o, 78mm, 78q(a) and (b), and 78w(a), the Commission proposes to adopt new Rule 612.

4. Small Entities Subject to the Rule

The proposed rule would apply to any national securities exchange, national securities association, ATS, vender, or broker or dealer. ATSs that are not registered as exchanges are required to register as broker-dealers. Accordingly, ATSs would be considered small entities if they fall within the standard for small entities that would apply to broker-dealers.

The proposed rule would prohibit these entities from accepting, ranking or displaying orders, quotes, or indications of interest in a pricing increment finer than a penny in NMS stocks, other than those with a share price below $1.00. The proposed rule would apply to a wide variety of market participants. Each is discussed below.

a. National Securities Exchanges and National Securities Association

None of the national securities exchanges is a small entity as defined by Commission rules. Paragraph (e) of Exchange Act Rule 0-10[267] states that the term "small business," when referring to an exchange, means any exchange that has been exempted from the reporting

[267] 17 CFR 240.0-10.

requirements of Exchange Act Rule 11Aa3-1. There is one national securities association, which is not a small entity as defined by 13 CFR 121.201.

b. Broker-Dealers

Commission rules generally define a broker-dealer as a small entity for purposes of the Exchange Act and the RFA if the broker-dealer had a total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, and the broker-dealer is not affiliated with any person (other than a natural person) that is not a small entity.[268] The Commission estimates that as of 2002, there were approximately 880 Commission-registered broker-dealers that would be considered small entities for purposes of the statute that would be required to comply with the proposed rule's provisions regarding access to quotations and quotation standardization.

c. Vendors

A vendor is defined in Exchange Act Rule 11Aa3-1(a)(11) as any securities information processor engaged in the business of disseminating transaction reports or last sale data with respect to transactions in reported securities to brokers, dealers or investors on a real-time or other current and continuing basis, whether through an ECN, moving ticker or interrogation device. Paragraph (g) of Exchange Act Rule 0-10 states that the term "small business," when referring to a securities information processor, means any securities information processor that: (1) Had gross revenues of less than $10 million during the preceding fiscal year (or in the time it has been in business, if shorter); (2) Provided service to fewer than 100 interrogation devices or moving tickers at all times during the preceding fiscal year (or in the time that it has been in business, if shorter); and (3) Is not affiliated with any person (other than a natural person) that is

[268] 17 CFR 240.0-10(c).

not a small business or small organization under this section. The Commission estimates that there are approximately 80 vendors but only 20% of these or 16 are considered small entities. The Commission seeks comment on whether these estimates are accurate.

5. Reporting, Recordkeeping, and other Compliance Requirements

Proposed Rule 612 would not impose any new reporting, recordkeeping or other compliance requirements on market participants that are small entities.

6. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap or conflict with the proposed rule.

7. Significant Alternatives

Pursuant to Section 3(a) of the RFA,[269] the Commission must consider the following types of alternatives: (a) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the proposed rule, or any part thereof, for small entities.

The primary goal of the proposed rule is to provide a uniform pricing increment for NMS stocks. As such, we believe that imposing different compliance or reporting requirements, and possibly a different timetable for implementing compliance or reporting requirements, for small entities could undermine the goal of uniformity. In addition, we have concluded similarly that it would not be consistent with the primary goal of the proposal to further clarify, consolidate or simplify the proposed rule for small entities. The Commission also does not believe that it is

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[269] 5 USC 603 (c).

necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed rule because the rule already proposes performance standards and does not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed rule. The Commission also preliminarily believes that it would be inconsistent with the purposes of the Exchange Act to specify different requirements for small entities or to exempt broker-dealers from the proposed rule.

8. Request for Comments

The Commission encourages written comments on matters discussed in the IRFA. In particular, the Commission requests comments on (i) the number of small entities that would be affected by the proposed rule; (ii) the nature of any impact the proposed rule would have on small entities and empirical data supporting the extent of the impact; and (iii) how to quantify the number of small entities that would be affected by and/or how to quantify the impact of the proposed rule. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rule is adopted, and will be placed in the same public file as comments on the proposed rule itself. Persons wishing to submit written comments should send three copies to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-10-04. Comments submitted by e-mail should include this file number in the subject line. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Electronically submitted letters also will be posted on the Commission's Internet web site (http://www.sec.gov).

VI. Market Data Proposal

A. Introduction

The Commission is proposing to amend the rules and joint industry plans for disseminating market information to the public. Pursuant to these arrangements, participants in the U.S. markets have real-time access to the best quotes for and trades in the thousands of stocks that are listed on a national securities exchange or Nasdaq. For each security, this information is disseminated on a consolidated basis. Quotes and trades are continuously collected from the many different market centers (i.e., exchanges, market makers, and ATSs) that simultaneously trade a security and then disseminated to the public in a single stream of information. Consolidated market information has been an essential element in the success of the U.S. securities markets. It is the principal tool for assuring the transparency of buying and selling interest in a security, for addressing the fragmentation of trading among many different market centers, and for facilitating the best execution of investor orders by their brokers.

The arrangements for disseminating market information were developed in the 1970's when Congress enacted Section 11A of the Exchange Act, mandating the creation of the NMS. To assure the public availability of market information, the Commission adopted Rules 11Aa3-1, 11Ac1-1, and 11Ac1-2 under the Exchange Act. The SROs comply with these rules by participating in three joint industry plans ("Plans").[270] Pursuant to the Plans, three separate

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[270] The three joint-industry plans are (1) the CTA Plan, which is operated by the Consolidated Tape Association and disseminates transaction information for exchange-listed securities, (2) the CQ Plan, which disseminates consolidated quotation information for exchange-listed securities, and (3) the Nasdaq UTP Plan, which disseminates consolidated transaction and quotation information for Nasdaq-listed securities. The last restatements of the CTA Plan and the CQ Plan were approved in 1996. See Securities Exchange Act Release No. 37191 (May 9, 1996), 61 FR 24842 (File No. SR-CTA/CQ-96-1). The amended versions of the CTA Plan and the CQ Plan were filed as attachments to File No. SR-CTA/CQ-96-1, which are available in the Commission's Public Reference

networks disseminate consolidated market information for NMS Stocks: (1) Network A for securities listed on the NYSE, (2) Network B for securities listed on the Amex and other national securities exchanges, and (3) Network C for securities traded on Nasdaq.[271] For each security, the data includes (1) an NBBO with prices, sizes, and market center identifications,[272] (2) a montage of the best bids and offers from each SRO that includes prices, sizes, and market center identifications, and (3) a consolidated set of trade reports in the security. The Networks establish fees for this data, which must be filed for Commission approval. In 2003, the Networks collected $424 million in revenues derived from market data fees and, after deduction of Network expenses, distributed $386 million to their individual SRO participants.[273]

As the equity markets evolved in recent years, strains began to develop in these market data arrangements, particularly with respect to setting fees for the data and allocating revenues to SROs. In December 1999, the Commission published a concept release on market information fees and revenues.[274] It requested public comment on a wide range of issues, including (1) a potential cost-based approach for evaluating the reasonableness of fees, (2) new criteria for distributing Network net income to SROs, (3) increased Plan and SRO disclosure, and (4)

Room. The Nasdaq UTP Plan was last published in its entirety in 2001. See Securities Exchange Act Release No. 44822 (September 20, 2001), 66 FR 50226 (File No. S7-24-89). There have been several subsequent amendments to the Plans; the Plans have not been republished in this connection.

271 Proposed Rule 600 under Regulation NMS defines the term "NMS Stock" to mean securities that are covered by the Plans.

272 Proposed Rule 600 under Regulation NMS defines the term "national best bid and national best offer."

273 See infra, section VI.C.1 (table setting forth revenues, expenses, and allocations of net income for Networks A, B, and C).

274 Securities Exchange Act Release No. 42208 (Dec. 9, 1999), 64 FR 70613 ("Concept Release").

improved Plan governance, administration, and oversight. In response, the Commission received many comments that addressed market data arrangements in great depth, but also reflected serious divisions in the securities industry over how best to regulate market information.

To help resolve these divisions, the Commission established an Advisory Committee on Market Information ("Advisory Committee") in the summer of 2000. The Advisory Committee, chaired by Professor Joel Seligman, was given a broad mandate to explore both fundamental matters, such as the benefits of price transparency and consolidated information, and practical issues, such as the best model for collecting and disseminating market information. The Advisory Committee issued its report in September 2001.[275] It made a variety of recommendations, including (1) retaining price transparency and consolidated market information as core elements of the U.S. securities markets, (2) permitting market centers to distribute additional information, such as depth of limit order book, free from mandatory consolidation requirements, (3) adopting a "competing consolidators" model of data dissemination, (4) broadening governance of the Plans through a non-voting advisory committee, and (5) rejecting a cost-based approach for reviewing fees.

Today, the Commission is proposing amendments that would implement most of the Advisory Committee recommendations. In particular, the amendments are intended to retain the core benefits of the current rules – price transparency and consolidated information – while enhancing their fairness and efficiency. To this end, the amendments would authorize the independent distribution of additional data by individual market centers, as well as establish

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[275] Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change (September 14, 2001) (available at http://www.sec.gov) ("Advisory Committee Report"). The Advisory Committee Report includes a comprehensive description of the arrangements for disseminating market data to the public, including the terms, fees, and revenues of the Plans.

uniform standards for the terms on which such is data is distributed. Rule 11Ac1-2 (proposed to be redesignated as Rule 603 of Regulation NMS), which requires the consolidated display of information, would be revised to streamline its requirements and to ease its burden of compliance. The amendments also would broaden participation in Plan governance to help assure that interested parties other than SROs have an opportunity to be heard. For the reasons discussed in Section VI.B.2 below, however, the Commission has decided not to propose the adoption of a competing consolidators model for market data dissemination.

Finally, today's proposal is intended to address the serious economic and regulatory distortions caused by the current Plan formulas for allocating Network net income to the SROs. The formulas currently are based solely on the number of trades or share volume reported by an SRO. They therefore do not directly reward those market centers that generate the highest quality quotes – i.e., those quotes that have the best prices and the largest sizes that contribute the most to price discovery. Moreover, the exclusive focus on trade reporting has distorted SRO competition and created incentives for "print facilities," "wash" trades and "shredded" trades solely to maximize market data revenues.[276] The proposed new formula would adopt a broad-based measure of an SRO's contribution to a Network's data stream. The new allocation formula, along with the other amendments proposed today, is intended to address those elements of the current market data arrangements that are most in need of reform, while retaining for investors the vitally important benefits of price transparency and consolidated information.

B. Consideration of Alternative Models

Since receiving the Advisory Committee Report, the Commission has undertaken an extended review of alternative models for disseminating market information to the public. The

[276] See infra section VI.C.1.

current model offers many benefits to investors and other information users, particularly with respect to the quality of information disseminated by the three Networks. These Networks have established a solid record over the years for disseminating information that is accurate and reliable. Moreover, the Networks assure that the best prices offered by all significant market centers trading a particular security are readily available from a single source. The most significant weakness of the current model, however, is that it affords little opportunity for market forces to determine a Network's fees, or the allocation of those fees to a Network's SRO participants. The Networks are the exclusive processors of consolidated information for NMS Stocks, and the consolidated display requirement necessarily means that all users of market information must purchase the Networks' data at the Networks' fees.

The Commission's review has focused on three alternatives to the current model: (1) a deconsolidation model recommended by a minority of the Advisory Committee; (2) a competing consolidators model recommended by the majority of the Advisory Committee; and (3) a hybrid model that would have retained a consolidated NBBO, but deconsolidated trades and all quotes other than the NBBO. The primary goal of each alternative is to introduce greater competition and flexibility into the dissemination of market data. Each, however, appears to have significant drawbacks. The Commission is discussing its analysis of these models to inform the public of the basis of its decision not to propose one of the alternative models and to offer the public an opportunity to comment on the issue.

At the outset, it is important to recognize the difficulties involved in attempting to choose the best available model. No matter which of the three alternatives is considered, serious trade-offs of benefits and drawbacks must be accepted. In particular, there is an inherent tension between the objectives of assuring price transparency and the public availability of market

information, which is are fundamental objectives of the Exchange Act,[277] and the objective of expanding the operation of market forces with respect to data fees and revenue allocation. The Commission's primary goals in resolving these competing objectives can be divided into three broad categories: (1) maintaining the quality of information that is disseminated to the public; (2) assuring the reasonableness of fees that would preserve the wide public availability of market information; and (3) improving the distribution of fee revenues to reward those SROs that contribute the most to public price discovery. The following discussion reflects these goals.

1. Deconsolidation Model

A minority of the Advisory Committee recommended a deconsolidation model,[278] which would eliminate the requirement that vendors and broker-dealers provide consolidated data to their customers. As a result, the Plans and Networks would no longer be necessary. Each market center would be required to distribute its own information directly to multiple vendors and brokers, and would establish its own fees for the information. Investors and other users (including other market centers) could refrain from purchasing a market center's data if they did not believe its value was worth the fee. The strength of this model is the maximum flexibility it allows for competitive forces to determine data products, fees, and SRO revenues.

The deconsolidation model's most significant drawback, however, is the risk of confusion and harm to retail investors. Currently, retail investors are able, when making a trading or order-routing decision, to assess prices and evaluate the best execution of their orders by reviewing data from a single source. Because of the consolidated display requirement, they are assured that the data they receive reflects the best quotes and most recent trade price for a

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[277] Exchange Act Section 11A(a)(1)(C)(iii).

[278] Advisory Committee Report, supra note 275, section VII.B.1.

security, no matter where such quotes and trade are displayed in the NMS. If the consolidated display requirement were eliminated, retail investors would need to monitor the quality of the data disseminated by brokers and vendors. These brokers and vendors simultaneously could be displaying a variety of "best" quotes and "last" trade prices for a single security. Although some retail investors might have the time, inclination, and knowledge to sort through these issues, many likely would not.

Retail investors should not be required to become experts on market structure to participate directly in the equity markets with confidence that they will receive a fair deal. The Commission believes that assuring retail investors ready access to consolidated prices is a vital benefit of the current model of data dissemination. In addition, the consolidated stream of best quotes and trades for a security is the single most important tool for unifying the many different market centers that simultaneously trade NMS Stocks into something that truly can be called a national market system. A substantial majority of the Advisory Committee affirmed its support for the consolidated display requirement.[279]

A second serious drawback to the deconsolidation model is the problem of market power. The quote and trade information from a dominant securities market may be so necessary that it can charge monopoly-like fees for its information. High fees could curtail access to this market information, harming some users of the information. In turn, these fees could prompt calls for active rate regulation. In light of the potential investor confusion and market power drawbacks, the Commission has decided not to propose an alternative model that would eliminate the consolidated display requirement and compromise the benefits it provides.

2. Competing Consolidators Model

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[279] Advisory Committee Report, supra note 275, section VII.B.1.

A majority of the Advisory Committee recommended the adoption of a model with competing consolidators.[280] This model would retain the consolidated display requirement, but the Plans and Networks with their central processors would no longer be required. Instead, each SRO would be allowed to separately establish its own fees that are not unreasonably discriminatory, to separately enter into and administer its own market data contracts, and to provide its own data distribution facility. Any number of data vendors or broker-dealers ("competing consolidators") could purchase data from the individual SROs, consolidate the data, and distribute it to investors and other data users.

The Advisory Committee identified four primary benefits that might result from implementation of this model. First, it believed that market participants would have a greater ability to innovate. Dissolution of the Plans' joint governance structure might allow for modifications to occur more quickly in response to new technologies and market opportunities. Second, it believed that dismantling the Plans would lead to ancillary gains. Rather than acting in concert on market data matters, SROs would no longer have the burdens associated with joint administration, along with potential antitrust exposure. Third, explicit information sharing arrangements imposed by the Plans on their participants would be eliminated. The Committee believed that the elimination of this artificial cooperation among competitors could enhance the forces of competition. Fourth, the arrangements under which market data revenues are allocated among Plan participants would be eliminated. Because each market separately would establish and collect its own fees, intermarket competition could be enhanced.

The Commission has considered carefully the merits of the competing consolidators model. It has decided not to propose the model for adoption, however, because it does not

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[280] Advisory Committee Report, supra note 275, section VII.C.2.

believe that the potential benefits of the model are sufficient to justify the model's serious drawbacks. First, the use of multiple consolidators necessarily entails a risk of loss of uniformity in the data that is distributed to the public. The Advisory Committee was fully aware of this risk and specifically discussed four types of quality problems. These related to sequencing of information, validation tolerances, capacity, and data protocols and formats. The Advisory Committee believed, however, that such problems could be overcome. The Commission agrees that the potential severity of these problems could be limited, but remains concerned about the risk that data quality could be compromised. In addition, switching to a competing consolidators model could lead to an increase in processing costs caused by having many consolidators perform tasks that currently are performed by a single processor per Network. Such costs ultimately would be borne by investors and other data users.

Another significant drawback of the competing consolidators model is that it would not introduce any additional market forces into the setting of data fees and the receipt of revenues by SROs. To comply with the consolidated display requirement, all vendors and broker-dealers acting as competing consolidators would have no choice but to obtain data from each of the SROs that trade a security. The fees set by the SROs for their data would be filed for Commission approval. Over the years, the Commission primarily has relied on the ability of the Networks to forge a broad industry consensus supporting their fees before they are filed for Commission approval.[281] If the competing consolidators model were adopted, this consensus underlying a single fee for a Network's stream of data would be lost. In reviewing the fees of individual SROs, the Commission could be called upon to resolve a host of difficult issues raised by commenters on the fees, particularly if the new fees set by all of the SROs collectively added

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[281] See Concept Release, supra note 274, section III.C.

up to a substantial increase over the total fees currently charged by the Networks. The Advisory Committee did not support the primary criterion that the Commission discussed in its Concept Release – that an SRO's data fees should be reasonably related to the SRO's costs to generate and disseminate the data. The Committee believed that a cost-based standard would be unwise and ultimately prove unworkable. It did not, however, offer an alternative objective criterion, nor is the Commission aware of such a criterion, that could be used to resolve fee disputes in an even-handed fashion.

In summary, the most significant potential benefits of the competing consolidators model would inure most directly to the SROs, which no longer would be required to act jointly through the Plans. Investors and other data users, however, would bear the most significant potential risks of switching to a new model – higher fees for lower quality information. The Commission therefore has decided not to propose the competing consolidators model for adoption.

3. Hybrid Model

Finally, the Commission considered a "hybrid" approach that would have retained the key elements of the current model (e.g., the consolidated display requirement, Plans, and Networks) for quotes representing the NBBO, but deconsolidated all trade reporting and all quotes other than the NBBO. Given that the range of data disseminated by the Networks would be cut back significantly, the fees for Network data also would be cut back, by as much as 75% for example. The remaining net income of a Network could be distributed to SROs pursuant to a revised allocation formula analogous to the one proposed in Section VI.C.2 below. All other data currently disseminated by the Networks – all trades and the best bids and offers from individual SROs that do not represent the NBBO – would be deconsolidated. Each SRO would distribute its data separately, as was discussed above with respect to the deconsolidation model.

A variant of this hybrid approach would provide a slimmed-down NBBO, with only the best prices and little other information, which would be distributed by the Network for the cost of collecting, processing, and disseminating this reduced NBBO.

The most significant strength of the hybrid model is that it potentially would preserve a baseline level of consolidated data most needed by retail investors – the NBBO – while at the same time affording a much greater opportunity for market forces to determine the fees for trades and non-NBBO quotes of the individual SROs. All investors would continue to have access to the NBBO for purposes of making trading decisions and evaluating the best execution of their orders. For other data, the SROs would be free to establish their own fees, subject to Commission approval. In the absence of a consolidated display requirement, investors and data users would be free to not purchase an SRO's data if they believed its value did not justify the fee.

The hybrid model, however, suffers from many of the significant drawbacks of the other alternatives. First, as discussed above, issues relating to the quality of data would need to be addressed, such as the problem of preserving uniformity when data is disseminated by many different processors. Perhaps most important, however, is the issue of whether market forces could be relied upon to assure reasonable fees for market data that would preserve its wide availability. As discussed previously, an SRO with a significant share of trading in NMS Stocks potentially could exercise market power in setting fees for its data. Few investors could afford to do without the best quotes and trades of an SRO that is dominant in a significant number of stocks. Therefore, instead of introducing greater competitive forces into the fee-setting process, the hybrid model could embroil the Commission in highly contentious disputes when a dominant SRO's fees were filed for approval. Moreover, as noted above in the context of the competing

consolidators model, there does not appear to be any widely-accepted, objective, and workable standard for resolving such disputes in an evenhanded fashion.

The Commission therefore has decided not to propose the hybrid model for adoption. At its heart, this decision is based on the Commission's belief that investors and other data users are the most significant beneficiaries of the current model. They receive high-quality data at affordable fees, and must only deal with one administrator and processor per Network to obtain a complete set of the best quotes and trades from all SROs. In contrast, the significant drawbacks of the current model are experienced most directly by the SROs and other industry participants. Rather than switch to a new model and risk compromising the benefits currently enjoyed by investors, the Commission has chosen to propose specific solutions to the most pressing and serious problems with the current model.

The Commission requests comment from the public on its evaluation of the relative strengths and weaknesses of the current model and of the various alternatives. In particular, are investors and other information users relatively satisfied with the current products and fees offered by the Networks? If not, would investors and users fare better under one of the alternative models considered by the Commission, or under another type of model? How serious are the data quality issues that might arise when multiple processors individually and simultaneously collect and disseminate data for the same security from many different market centers? If the Commission adopted a partly or fully deconsolidated model, would market forces alone be sufficient to establish fees that would assure the wide availability of data, or would the Commission need to play an active role in reviewing fees? What standards would be available to guide the Commission in reviewing the fairness and reasonableness of fees?[282] Are such

[282] See Exchange Act Section 11A(c)(1)(C).

standards objective and workable, or would they require the exercise of considerable discretion by the Commission?

C. Allocation of Network Net Income

The Commission is proposing an amendment to the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan that would change the current formulas for allocating the Plans' net income to their SRO participants. The new formula is intended to establish a more broad-based measure of an SRO's contribution to a Network's data stream than is provided by the current formulas.[283]

1. Current Plan Formulas

The current allocation formulas for the Networks' distributable net income are based on the number or share volume of an SRO's reported trades in Network securities. Network A and Network B allocate net income based solely on the number of trades reported by an SRO.[284] Network C allocates net income based on an average of a participant's number of trades and its share volume.[285] These formulas are used to distribute very substantial amounts of Network net

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[283] In the Concept Release, supra note 274, the Commission requested comment on whether the Plan allocation formulas should be revised to reflect more directly the value that each SRO's information contributed to the stream of consolidated market data. The commenters were almost evenly split on this issue. Five preferred maintaining the current system. They particularly noted the difficulty in designing a formula that would accurately accord different values to quotations, in a manner that would provide a meaningful incentive to improve markets. Four commenters believed that the current formulas should be revised to reflect high-quality market data, although each proposed different formulas to achieve this result.

[284] Paragraph XII(a)(iii) of the CTA Plan provides that a CTA Network's net income shall be allocated among its SRO participants according to their respective "Annual Shares." Annual Share is defined in paragraph XII(a)(i) as a fraction of which (1) the numerator is the number of trades in Network securities reported by a particular SRO, and (2) the denominator of which is the total number of trades in Network securities reported by all SROs. Paragraph IX(a)(i) of the CQ Plan incorporates by reference the CTA Plan's definition of Annual Share.

[285] Exhibit 1(1) to the Nasdaq UTP Plan provides that net income shall be allocated in accordance with an SRO's "percentage of total volume." Percentage of total volume is

income. The following table sets forth the Networks' revenues, expenses, and net income in 2003, along with the allocation of net income to the various SROs:

2003 Financial Information for Networks A, B, and C[286]

	Network A	Network B	Network C	Total
Revenues	$171,462,000	$99,179,000	$153,686,000	$424,327,000
Expenses	9,322,000	3,508,000	25,470,000	38,300,000
Net Income	162,140,000	95,671,000	128,216,000	386,027,000
Allocations:				
NYSE	145,610,000	2,826,000	0	148,436,000
NASD/Nasdaq	8,907,000	18,895,000	87,716,000	115,518,000
PCX	1,056,000	18,662,000	19,058,000	38,776,000
Amex	0	36,189,000	32,000	36,221,000
NSX	795,000	10,828,000	20,661,000	32,284,000
CHX	3,208,000	4,450,000	706,000	8,364,000
BSE	2,234,000	2,516,000	43,000	4,793,000
Phlx	330,000	1,276,000	0	1,606,000
CBOE	0	29,000	0	29,000

By focusing exclusively on the number of trades, no matter how small the trade, and the share volume of trading to compensate SROs for their contribution to a Network's data stream, these formulas have caused a variety of economic and regulatory distortions. First, although quotes are disseminated by the Networks, the formulas do not reward those market centers that generate the highest quality quotes -- i.e., those quotes that have the best prices and the largest sizes. Such quotes are a critically important source of public price discovery, yet currently are irrelevant to an SRO's share of Network net income. Conversely, reports of very small trades often have less value for purposes of price discovery, yet the report of a 100-share trade is given equal weight with the report of a 5000-share trade under the current Network A and B formulas.

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defined in Exhibit 1(2) as the average of an SRO's percentage of total trades in Network securities and its percentage of total share volume in Network securities.

286 The Network financial information for 2003 is preliminary and unaudited.

Second, the trade-based formulas create an incentive for SROs to operate "print facilities" that report a large number of trades. These SROs attempt to attract business by awarding percentage rebates (e.g., 50% and higher) of their data revenues to ATSs and market makers that agree to report their trades through the SRO. The ATS or market maker may otherwise have little connection with the SRO. To compete with print facilities, other SROs are forced to offer rebates as well. As a result, the purely commercial consideration of maximizing market data revenues, rather than the quality of an SRO's regulatory expertise or trading services, may determine which SRO is responsible for reporting (and regulating) a trade. In addition, some ATSs and market makers have chosen to display quotes through one SRO and report trades to another – potentially causing confusion about where liquidity is to be found.

Finally, the exclusively trade-based formulas create an incentive for fraudulent or distortive practices, particularly by reporting a large number of very small trades. As a result, market participants have engaged in illegal wash trades solely to generate market data revenues.[287] Some market participants also "shred" their total trading volume into the smallest possible trade sizes to maximize the amount of data revenues such trading can generate. Such practices detract from the accuracy and usefulness of the Network data streams.

2. Proposed New Formula

The Commission believes that the existing allocation formulas are greatly in need of reform. In particular, the formulas should incorporate a more broad based measure of the contribution of an SRO's quotes and trades to the consolidated data stream. By expanding the

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[287] NASD News Release, "NASD Settles Charges Against Swift Trade Securities for Deceptive Trading and Non-Bona Fide 'Wash' Transactions in QQQ," (Oct. 16, 2002) ("fictitious wash transactions were part of an effort to obtain market data revenue generated from such transactions").

scope of the existing formulas, many of the regulatory and economic distortions discussed above could be alleviated.[288]

The Commission is proposing an amendment to each of the Plans ("Formula Amendment") that is intended to achieve this objective.[289] The new formula reflects a two-step process. First, a Network's distributable net income (e.g., $150 million) would be allocated among the many individual securities (e.g., 3000) included in the Network's data stream. Second, the net income that is allocated to an individual security (e.g., $200,000) then would be allocated among the SROs based on measures of the utility of their trades and quotes in the security. The Formula Amendment provides that, notwithstanding any other provision of a Plan, its SRO participants are entitled to receive an annual payment for each calendar year that is equal to the sum of the SRO's Trading Shares, Quoting Shares, and NBBO Improvement Shares in each Network security for the year. These three types of Shares are dollar amounts that are calculated based on SRO trading and quoting activity in each Network security. The Trading, Quoting, and NBBO Improvement Shares then are added together to determine an SRO's total allocation of net income for the year.

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288 In 2002, the Commission abrogated several of the more extreme SRO proposals for rebating data revenues to market participants. Securities Exchange Act Release No. 46159 (July 2, 2002), 67 FR 45775. The purpose of the abrogation was to allow more time for the Commission to consider market data issues. Given that the existing Plan allocation formulas would be changed to reward more beneficial quoting and trading behavior, the Commission anticipates that rebates would be permitted in the future, assuming their terms meet applicable Exchange Act standards and SROs are able to meet their regulatory responsibilities.

289 Given the close connection between fees for access to quotes and allocating net income to SROs based on their quoting activity, the terms of the proposed allocation formula are closely related to adoption of the restrictions on access fees in the market access proposal. The Commission requests comment on whether quotes displayed by market centers that charge an access fee should be entitled to earn an allocation of market data net income pursuant to the measures of quoting activity discussed below.

Although the Formula Amendment appears complicated at first sight, it is important to keep in mind that only SROs and other industry participants will need to deal with the formula directly, and that the formula will control the allocation of hundreds of millions of dollars. No matter what formula ultimately is adopted, those parties most affected by it will soon know its details intimately. Accordingly, the Commission's primary objective is to adopt a formula that is as serviceable and useful as possible, even at the cost of somewhat increased complexity.

a. Security Income Allocation

The first step of the proposed new formula is to allocate a Network's total distributable net income among the many different securities that are included in a Network (the "Security Income Allocation"). Paragraph (b) of the Formula Amendment bases this allocation on the square root of dollar volume of trading in each security. Other potential alternatives would be to allocate net income equally among Network securities, or to allocate net income based directly on the trading volume in Network securities. The Commission has proposed to use the square root of dollar volume, for the following reasons.

Allocating a Network's net income equally among all of its securities would fail to recognize the differing value of quotes and trades for securities that are heavily traded versus those that are rarely traded. Consequently, the initial allocation of a Network's net income among individual securities should reflect the level of trading in each security. On the other hand, the allocation formula also should adjust for the highly disproportionate level of trading in the very top tier of Network securities. A small number of securities (e.g., the top 5%) are much more heavily traded than the other thousands of Network securities. Consequently, an allocation among individual securities that simply was directly proportional to trading volume would fail to reflect adequately the importance of price discovery for the vast majority of Network securities.

Under the Formula Amendment, the distribution of net income among all Network securities would be in proportion to the square root of the total dollar volume in the security. The dollar volume represents the importance of trading activity in each security. Since the marginal value of a quote diminishes as the number of quotes increases, the net income allocated to a security should not increase in a linear fashion with the activity in the security. Information-theoretic arguments from market microstructure theory suggest that the information in volumes increases only with the square root of volume.[290]

The Commission preliminarily believes that it is appropriate to reward those SROs whose quoting and trading activity extends broadly throughout the thousands of stocks included in a Network. Comment is requested on this issue and whether the use of the square root function adequately achieves this objective. Comment also is requested on whether other criteria would be more suitable for allocating net income among individual securities. For example, would using the square root of trades, rather than dollar volume, better reflect the tiered nature of trading volume, while also minimizing the potential for anomalous results for very inactively traded securities?

b. Measures of Trading and Quoting

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290 Some basic probability theory underlies the motivation for using the square root specification: The variance of a sum of innovations to a random walk is proportional to the number of terms in that sum. The standard deviation of the sum, which is the square root of its variance, is proportional to the average size of the sum. The standard deviation thus is proportional to the square root of the number of terms in the sum.

Substantial theoretical and empirical research in finance suggests that prices generally follow a random walk and that prices change in response to trades with large trades having greater impact than small trades, on average. Since it is reasonable to associate the flow of information in price changes with the average size of price changes, the price change standard deviation is a sensible measure of the flow of information in prices. Combining these facts suggests that the information in prices on average should be roughly proportional to the square root of volume.

After a specific amount of Network net income has been allocated to an individual security (i.e., the Security Income Allocation), this amount must be allocated further among the various SROs that transmit trades and quotes in the security to the Network processor. Paragraphs (c) through (e) of the Formula Amendment provide for this allocation according to three measures of an SRO's contribution to a Network's data stream: (1) the SRO's proportion of trading in each Network security ("Trading Share"); (2) the SRO's proportion of quotes with prices that equal the NBBO in each Network security ("Quoting Share"); and (3) the SRO's proportion of quotes that improve the price of the NBBO in each Network security ("NBBO Improvement Share").

i. Trading Share

Under paragraph (c) of the Formula Amendment, an SRO's Trading Share in a particular Network security would be a dollar amount that is determined by multiplying (i) an amount equal to the lesser of (A) 50% of the Security Income Allocation for the Eligible Security or (B) an amount equal to $2.00 multiplied by the total number of qualified transaction reports disseminated by the Processor in the Eligible Security during the calendar year, by (2) the SRO's Trade Rating in the security. A Trade Rating would be a number that represents the SRO's proportion of dollar volume and qualified trades in the security, as compared to the dollar volume and qualified trades of all SROs. The Trade Ratings of all SROs would add up to a total of one. Thus, for example, multiplying 50% of the Security Income Allocation for a Network security (e.g., $200,000) by an SRO's Trade Rating in that security (e.g., 0.2555) would produce a dollar amount (e.g., 50% x $200,000 x 0.2555 = $25,550) that is the SRO's Trading Share for the security for the year.

Applying 50% of the Security Income Allocation to the Trading Share reflects a judgment that generally trades and quotes are of approximately equal importance for price discovery purposes. For securities with lower trading volume, however, this percentage can disproportionately reward a small number of trades during the year, at the expense of those markets that aggressively quote a security throughout the year. For example, the Security Income Allocation for a security with 10 qualified trades during the year might be $300. Rather than allocate the full $300 to those SROs that reported a small number of trades (for an average per trade allocation of $30), the proposed formula includes a cap of $2 per qualified transaction report, so that a total of only $20 would be allocated pursuant to the Trading Share. The difference of $280 ($300 minus $20) is shifted to the Quoting Share to reward those markets that consistently displayed valuable quotes in the security throughout the more than 250 trading days during the year. The amount of the cap of $2 per qualified transaction report exceeds the highest amount per transaction report currently allocated for any of the three Networks.

An SRO's Trade Rating would be calculated by taking the average of (1) the SRO's percentage of total dollar volume reported in the Network security during the year, and (2) the SRO's percentage of total qualified trades reported in the Network security for the year. To be qualified, a trade must have a dollar volume of $5000 or higher. This dollar volume would reflect, for example, a 200-share trade at a price of $25 per share. Analysis of Network A data indicates that this threshold would include approximately 50% of total trades and approximately 90% of total dollar volume. The purpose of this minimum size requirement is, first, to eliminate those very small trades that often have the least price discovery value and, second, to reduce the potential for significant numbers of "shredded" trades.

The use of a standard that allocates 50% of Network net income based solely on dollar volume and qualified trades in Network securities is intended to reward an SRO for its contribution to the consolidated stream of trade reports disseminated by a Network, without regard to the value of the SRO's quotes. Comment is requested on whether 50% of a Security Income Allocation generally reflects an appropriate weighting for trading activity. In addition, is the cap on the average per trade allocation appropriate and, if so, is $2 per qualified trade an appropriate limit? Comment also is requested on whether dollar volume and qualified trades are appropriate measures of an SRO's contribution to the consolidated trade stream. Is a minimum size requirement appropriate for the number of trades criterion and, if so, should the amount be higher or lower than $5000? How would a minimum size requirement affect the handling or routing of investor orders? Alternatively, should trades with a size of less than $5000 receive some credit, but credit that is proportional to their smaller size (e.g., a $1000 trade would receive one-fifth the credit of a trade of $5000 or greater). Finally, should a cap be placed on the size of individual trades (e.g., $500,000 dollar volume) to prevent the allocation for exceptionally large trades from swamping the allocation for smaller trades?

ii. Quoting Share

Under paragraph (d) of the Formula Amendment, an SRO's Quoting Share in a particular Network Security would be a dollar amount that is determined by multiplying (i) an amount equal to 35% of the Security Income Allocation for the security, plus the difference, if greater than zero, between 50% of the Security Income Allocation for the Eligible Security and an amount equal to $2.00 multiplied by the total number of qualified transaction reports disseminated by the Processor in the Eligible Security during the calendar year, by (ii) the SRO's Quote Rating in the security. A Quote Rating would be a number that represents the SRO's

proportion of quotes that equaled the price of the NBBO during the year ("Quote Credits"), as compared to the Quote Credits of all SRO's during the year. The Quote Ratings of all SROs would add up to a total of one. Multiplying 35% of the Security Income Allocation for a Network security (plus any shifted allocation from the Trading Share) by an SRO's Quote Rating in that security would produce a dollar amount that is the SRO's Quoting Share for the security for the year.

An SRO would earn one Quote Credit for each second of time and dollar value of size that the SRO's quote during regular trading hours equals the price of the NBBO.[291] Thus, for example, a bid with a dollar value of $4000 (e.g., a bid of $20 with a size of 200 shares) that equals the national best bid for three seconds would be entitled to 12,000 Quote Credits. If an SRO quotes simultaneously at both the national best bid and the national best offer, it would earn Quote Credits for each quote.

With respect to SRO quotes that are not fully accessible through automatic execution,[292] however, the Formula Amendment would establish an automatic cut-off of Quote Credits when such quotes are left alone at the NBBO as a result of quote changes by other SROs. For example, if two SROs have transmitted bids with a price of $10 per share that represents the national best bid in a security, and one of those SROs subsequently lowers its bid to $9.98 per share, the second SRO will be left alone at the national best bid. If the second SRO's quote is fully accessible through automatic execution, its bid of $10 per share would continue to earn

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[291] Regular trading hours are defined in proposed Rule 600 of Regulation NMS as between 9:30 a.m. and 4:00 p.m. Eastern Time, unless otherwise specified pursuant to the procedures established in Rule 605(a)(2).

[292] The Commission preliminarily believes that an SRO's quotes would not be "fully accessible" unless all of such quotes are generated by market centers that qualify as an "automated order execution facility" under the proposed trade-through rule. See supra, section III.D.2. Comment is requested on whether this is an appropriate standard.

Quote Credits. If the second SRO's quote is not fully accessible through automatic execution, its bid of $10 per share would cease earning Quote Credits when the first SRO lowered its bid. The second SRO could recommence earning credits by retransmitting its bid to the Network processor to confirm a current willingness to trade at a bid price of $10.

The purpose of the automatic cut-off of Quote Credits for SRO quotes that are not fully accessible through automatic execution is to help assure that stale quotes are not highly rewarded. If an SRO's quote is left alone at the NBBO, it would be the only SRO earning Quote Credits throughout the time the quote remains alone at the NBBO. Given that other SROs have moved their prices away, the quote submitted by an SRO with manual trading may be in the process of being updated to reflect a new price. This quote may be the last to be updated because it is the least desirable, and it cannot be automatically executed. The SRO should not earn Quote Credits during this time. If, on the other hand, the SRO with manual trading remains willing to trade immediately at the old price, it has the opportunity to retransmit the quote and thereby recommence earning Quote Credits.

The use of time and size at the NBBO as a measure for allocating 35% of Network net income is intended to reward those SROs that contribute valuable quotes to a Network's data stream. Comment is requested on whether this measure achieves its purpose and is serviceable. For example, does rewarding SROs for the length of time of their quotes create such a powerful incentive for slowness in updating quotes that the accuracy and integrity of the consolidated quote stream itself would be seriously compromised? Does the automatic cut-off for quotes that are not fully accessible through automatic execution help ameliorate this problem? The Commission also requests comment on whether 35% is an acceptable weighting to place on this measure of quoting activity. As noted above with respect to the Trading Share, the total Security

Income Allocation for a security generally will be split evenly between trading activity and quoting activity. For quoting activity, the proposed formula allocates a higher amount to the Quoting Share than to the NBBO Improvement Share (35% compared to 15%). This allocation is based on a judgment that consistent quoting in size at the NBBO adds substantial depth to the market, and that the Quoting Share reflects a broader measure of quoting activity than the NBBO Improvement Share. In addition, any quote that qualifies for an NBBO Improvement Share necessarily would also qualify for a Quoting Share.

iii. NBBO Improvement Share

Under paragraph (e) of the Formula Amendment, an SRO's NBBO Improvement Share in a particular Network security would be a dollar amount that is determined by multiplying (i) 15% of the Security Income Allocation for such security by (ii) the SRO's NBBO Improvement Rating in the security. An NBBO Improvement Rating would be a number that reflects the proportion of an SRO's quotes that improve the price of the NBBO in a security ("NBBO Improvement Credits"), as compared to the NBBO Improvement Credits of all SROs in the security. The NBBO Improvement Ratings of all SROs would add up to a total of one. Multiplying 15% of the Security Income Allocation for a Network security by an SRO's NBBO Improvement Rating in that security would produce a dollar amount that is the SRO's NBBO Improvement Share for the security for the year.

An SRO would earn NBBO Improvement Credits in two ways. First, it would earn one NBBO Improvement Credit for each five seconds of time and dollar value of size that a quote transmitted by the SRO during regular trading hours improves the price of the existing NBBO in a security ("Qualified Quote") and continues to remain equal to the price of the NBBO on a going-forward basis. Second, an SRO would earn NBBO Improvement Credits for a Qualified

Quote equal to the total dollar volume of the SRO's transaction reports in the security that meet the following four conditions: (1) the transaction report must be transmitted to the Network processor subsequent to the Qualified Quote; (2) the transaction report must be transmitted while the price of the Qualified Quote remains equal to the NBBO or no later than five seconds after it no longer equals the NBBO; (3) the price of the transaction report must be the same as the price of the Qualified Quote; and (4) the total NBBO Improvement Credits earned for transaction reports connected with a single Qualified Quote cannot exceed the sum of the dollar value of size of such Qualified Quote plus the total NBBO Improvement Credits earned for the time and size of such Qualified Quote.

The following example is provided to illustrate the rules for calculating NBBO Improvement Credits. Assume that SRO #1 transmits a bid at 9:45:37 a.m. with a price of $10.00 and a size of 4000 shares, thereby improving the existing national best bid of $9.98. SRO #1's bid is a Qualified Quote and entitled to earn NBBO Improvement Credits. At 9:45:39 a.m., SRO #2 transmits a bid with a price of $10.00 and a size of 5000 shares. SRO #2's bid, even though it equals the price of SRO #1's bid and has greater size, does not affect the right of SRO #1 to earn NBBO Improvement Credits. At 9:45:40 a.m., SRO #1 transmits a transaction report with a price of $10.00 and a size of 1000 shares, and also lowers the size of its bid to 3000 shares. At 9:45:44 a.m., SRO #1 lowers its bid to $9.99. At 9:45:47, SRO #1 transmits a transaction report with a price of $10.00 and a size of 4000 shares.

In the foregoing example, SRO #1 would have earned a total of 80,000 NBBO Improvement Credits (30,000 credits for quoting plus 50,000 credits for trading). For the time and size of its bid, it earned 30,000 credits for maintaining the bid price at $10.00 (equal to the national best bid) for a full five-second increment with a size of 3000 shares. It is not entitled to

credits for the full 4000-share size of the initial bid because the size was not maintained for 5 seconds. For its trading, SRO #1 earned 10,000 credits for its first transaction report (which was transmitted while its bid price remained equal to the national best bid), and 40,000 credits for its second transaction report (which was transmitted within five seconds after SRO #1's bid no longer equaled the national best bid). Finally, the total of 50,000 credits for transaction reports does not exceed the maximum amount that could be earned for transaction reports (the maximum amount was 70,000 credits – 40,000 for the initial dollar value of size of the Qualified Quote, plus 30,000 for the total NBBO Improvement Credits earned for the time and size of the Qualified Quote).

The purpose of the NBBO Improvement Share is to reward SROs with quotes that frequently improve the prices of the NBBO, even if such quotes are soon matched by the quotes of other SROs. The five-second minimum for time and size of a price-improving quote is intended to assure the credits are not earned for ephemeral quotes that are posted and quickly withdrawn without trading. Credits are earned for trading connected to a price-improving quote to assure that (1) an SRO is rewarded for displaying a price-improving quote even if the quote is quickly taken out by an arriving order, and (2) an SRO is rewarded for continuing to trade when its quote is left displayed for more than five seconds. The cap on credits for trading is intended to maintain a reasonable relation between a price-improving quote and the total number of credits that can be earned for the quote (for example, if a price-improving quote with a size of 100 shares is followed by a transaction report with a size of 10,000 shares).

The Commission requests comment on the formula for calculating an NBBO Improvement Share. Does it achieve its objective of rewarding valuable quotes? Is a five-second time period the appropriate length to achieve its objective to preclude giving credit to

ephemeral quotes? Should an SRO also be allowed to earn credits for quotes that are left alone at the NBBO as a result of quote changes by other SROs, rather than just for quotes that improve the price of the NBBO? If a price-improving quote results in a locked or crossed market, should the quote be entitled to earn NBBO Improvement Credits? Should the weighting of 15% of a Security Income Allocation be higher or lower?

In addition, the Commission requests comment on whether the NBBO Improvement Share creates an unacceptable risk of "gaming" behavior by market participants that would harm the integrity of a Network's data stream. For example, unscrupulous market centers, seeking to qualify trades for NBBO Improvement Credits, potentially could engage in the practice of "flashing" quotes at an improved NBBO immediately prior to reporting a trade. These quotes would be transmitted to the Plan processor, even though the market center had no valid, prospective trading interest at the price (i.e., other than the trade that was already in hand and that the market center was attempting to qualify for NBBO Improvement Credits). The Commission notes that such quotes would be fraudulent and would violate a variety of Exchange Act provisions and rules. Comment is requested on whether the threat of enforcement action and sanctions would be sufficient to deter such behavior. Comment also is requested on whether other alternative approaches would more usefully measure the contribution of an SRO's quotes to a Network's data stream.

The Commission generally requests comment on the Formula Amendment as a whole, including whether it is workable and its potential effect on SROs, other industry participants, and investors. Are all of the elements of the formula necessary and appropriate to achieve the goal of rewarding markets for their contributions to the consolidated data stream? Adoption of the new formula could result in substantial shifts in the allocation of Network net income among the

various SROs. Given that changes in the allocation formula may lead SROs and market participants to alter their conduct, how probative are historical trading and quoting patterns in determining the future effect of a new formula? Comment is requested on the likelihood of major changes in existing levels of net income allocation and the potential effect on SROs that receive lesser amounts of income. For example, would potential shifts in the allocation of Network net income promote or detract from effective self-regulation of the markets? In this regard, comment is requested on the likely effect of the proposed formula on the current practice of some SROs to grant substantial rebates of Network net income to market participants.

Finally, comment is requested on the extent to which the net income allocation formula should be modified if some market centers continue to charge fees for access to their quotes. Under the market access proposal discussed in Section IV, such fees would be capped at a de minimis amount of $0.001 per share, and the accumulation of this fee would be limited to no more than $0.002 per share. If this limitation is not ultimately adopted, should the quotes and trades transmitted by market centers that charge fees higher than a de minimis amount also be entitled to receive an allocation of Network net income? Potentially, all quotes and all trades transmitted by such market centers could be excluded from the calculation of Trading Shares, Quoting Shares, and NBBO Improvement Shares, thereby eliminating any allocation of Network net income for such quotes and trades. Alternatively, only the quotes could be excluded from the calculation, with the trades continuing to qualify for an allocation of a Trading Share. Comment is requested on whether either of these alternatives would be appropriate, and also on any other alternatives that would more appropriately reflect the charging of access fees.

D. Plan Governance

The Commission is proposing an amendment to the Plans that would broaden participation in their governance ("Governance Amendment"). Currently, operating committees, composed of one representative from each SRO participant, govern the Plans.[293] In addition, the Networks have an administrator and a processor. For Network A, the administrator is the NYSE, and the processor is SIAC. For Network B, the administrator is Amex, and the processor is SIAC. For Network C, the current administrator and processor is Nasdaq.[294]

The Advisory Committee on Market Information recommended a number of changes to the governance of the Plans and operation of the Networks, including the creation of non-voting advisory committees to the Plans that would broaden participation in their governance.[295] The

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293 See generally Advisory Committee Report, supra note 275, section III, which includes a full description of the Plans' terms and governance, as well as the operation of the Networks.

294 See Securities Exchange Act Release No. 43863 (Jan. 19, 2001), 66 FR 8020 (extension of Nasdaq UTP Plan was conditioned on, among other things, bona fide competitive bidding for Nasdaq UTP Plan processor).

295 Advisory Committee Report, supra note 275, section VII.3.B. The Advisory Committee also recommended (1) enhanced industry efforts to streamline Plan administration, particularly the administration of vendor and subscriber contracts, and (2) mandatory competitive bidding for Network processors. The Commission agrees that efforts to enhance the efficiency of Plan administration should be encouraged, and believes that the proposal to broaden Plan governance could help assure that the Plans continue their cooperative efforts with the industry to streamline administration. The Commission does not believe, however, that the potential benefits currently would justify the costs of mandating periodic competitive bidding for Network processors. The Plans already provide for periodic evaluation of the processor and for replacement if its performance is unsatisfactory. Moreover, the Commission itself has authority, if necessary, to require a change of processor by initiating a Plan amendment.

The Advisory Committee considered, but did not recommend, changing the unanimous vote requirements currently included in the Plans. Although they vary somewhat in their particulars, the Plans generally require that significant matters, such as amendments to a Plan and reductions in fees, be approved by all of the Plan's SRO participants. On disputed matters, this requirement sometimes can result in gridlock. Eliminating the

Commission agrees that advisory committees potentially would improve Plan governance. In particular, the committees would help assure that the views of interested parties other than SROs have an opportunity to be heard on Plan matters, and that their views are heard prior to any decision on a matter by the Plan's operating committee. Earlier and more broadly based participation could contribute to the ability of the Plans to achieve a consensus on disputed issues.

Paragraph (b) of the Governance Amendment sets forth requirements for composition of the advisory committees. Members would be selected for two-year terms to allow sufficient time for them to gain familiarity with Plan business. The operating committee of a Plan would select, by majority vote, at least one representative from each of the following five categories: (1) a broker-dealer with a substantial retail investor customer base, (2) a broker-dealer with a substantial institutional investor customer base, (3) an ATS, (4) a data vendor, and (5) an investor. In addition, each SRO participant would have the right to select one committee member that is not employed by or affiliated with any participant.

Paragraphs (c) and (d) of the Governance Amendment set forth the function of an advisory committee and the requirements for its participation in Plan affairs. The function of an advisory committee is to assure that its members have an opportunity to submit their views to the operating committee on Plan matters, prior to any decision by the operating committee. Such Plan matters would include, but not be limited to, new or modified products, fees, procedures for fee administration, and pilot programs. To enable the advisory committee members to perform

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unanimous vote requirement would facilitate more flexible Plan decision-making, but also potentially would allow SROs that collectively represent only a minority of trading in Plan securities to dictate policy affecting all of the SROs. The Commission has decided not to propose an amendment to the Plans' unanimous vote requirements at this time, but requests comment on whether they should be modified in any respect.

their function properly, members would have the right to attend regular meetings of the operating committee and to receive any information relating to Plan business that was provided to members of the operating committee. The operating committee would retain the power, however, to meet in executive session if, by majority vote, it determined that an item of business required confidential treatment.

The Commission requests comment on whether the proposed advisory committees would achieve the goal of broadening participation in Plan matters in a useful way. Should the enumerated five categories of parties interested in Plan matters be expanded to include others? Does a two-year term afford members a sufficient time to gain familiarity with Plan business, without being so long that it deters individuals from participating? Comment also is requested on whether the types of Plan matters on which an advisory committee is entitled to submit views should be more specifically enumerated. Finally, is it useful and appropriate to allow advisory committee members to attend meetings of the operating committee and receive operating committee information (subject to the confidential treatment exception)? If the operating committee meets in executive session, should the Plan specify what the advisory committee must be informed about the business conducted at such session?

E. Proposed Amendments to Rules 11Aa3-1 and 11Ac1-2

The Advisory Committee on Market Information recommended that the Exchange Act rules governing distribution and display of market information be modified in two respects. First, it believed that individual market centers (including SROs, ATSs, and market makers) should have the freedom to distribute their own market data independently.[296] Such data could include "core information" – the trades and best quotes of a market center – which would

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[296] Advisory Committee Report, supra note 275, section VII.B.2.

continue to be transmitted to the Networks, but also additional information such as depth of order book. This additional information has become increasingly important as decimal trading has spread displayed depth across a greater number of price points. Second, the Advisory Committee recommended that the Commission should consider making the consolidated display requirement more flexible, again in order to promote wider distribution of data by individual market centers.[297] The Commission agrees and is proposing amendments to Exchange Act Rule 11Aa3-1 (proposed to be redesignated as Rule 601 of Regulation NMS) and Exchange Act Rule 11Ac1-2 (proposed to be redesignated as Rule 603 of Regulation NMS) to implement these recommendations. In addition, the Commission is adding a consolidation requirement to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) to make explicit in an Exchange Act rule what is currently the case in fact – all SROs must act jointly through NMS plans to disseminate consolidated market information in NMS Stocks to the public.

1. Independent Distribution of Information

Currently, paragraphs (c)(2) and (c)(3) of Rule 11Aa3-1 (proposed to be redesignated as Rule 601) prohibit SROs and their members from disseminating their trade reports independently.[298] Under the proposed amendment to the Rule, these paragraphs would be rescinded. Members of an SRO would continue to be required to transmit their trades to the SRO (and SROs would continue to transmit trades to the Networks pursuant to the Plans), but such members also would be free to distribute their own data independently, with or without fees.

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[297] Advisory Committee Report, supra note 275, section VII.B.1.

[298] Regulation NMS would remove the definitions in current paragraph (a) of Rule 11Aa3-1 and place them in Rule 600. Current subparagraphs (c)(2) and (c)(3) of Rule 11Aa3-1 are proposed to be rescinded. As a result, current subparagraph (c)(4) of current Rule 11Aa3-1 would be redesignated as subparagraph (b)(2) of Rule 601.

Although current rules do not prohibit the independent distribution of quotes, they do not establish standards for such distribution. Paragraph (a) of the proposed amendment to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) establishes uniform standards for distribution of both quotes and trades that would create an equivalent regulatory regime for all types of market centers. First, paragraph (a)(1) of the proposed amendment requires that any market information[299] distributed by an exclusive processor, or by a broker or dealer (including ATSs and market makers) that is the exclusive source of the information, be made available to securities information processors on terms that are fair and reasonable. Paragraph (a)(2) of the proposed amendment requires that any SRO, broker, or dealer that distributes market information must do so on terms that are not unreasonably discriminatory. These requirements would prohibit, for example, a market center from distributing its data independently on a more timely basis than it makes available the "core data" that is required to be disseminated through a Network processor. With respect to non-core data, however, the Commission preliminarily believes that market centers should have considerable leeway in determining whether, or on what terms, they provide non-core data to a Network processor. Such an entity may be in a unique competitive position. As Network processor, it acts on behalf of all markets in disseminating

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299 The information covered by the proposed amendment tracks the language of Section 11A(c) of the Exchange Act, which applies to "information with respect to quotations for or transactions in" securities. This statutory language encompasses a broad range of information, including information relating to limit orders held by a market center. See, e.g., S. Report No. 94-75, 94th Cong., 1st Sess. 9 (1975) ("In the securities markets, as in most other active markets, it is critical for those who trade to have access to accurate, up-to-the-second information as to the prices at which transactions in particular securities are taking place (i.e., last sale reports) and the prices at which other traders have expressed their willingness to buy or sell (i.e., quotations)."); H.R. Report No. 94-229, 94th Cong., 1st Sess. 93 (1975) (Section 11A grants Commission "pervasive rulemaking power to regulate securities communications systems").

consolidated information, yet it also may be closely associated with the competitor of a market center. Comment is requested on this issue.[300]

The "fair and reasonable" and "not unreasonably discriminatory" requirements are derived from the language of Section 11A(c) of the Exchange Act. Under Section 11A(c)(1)(C), the more stringent "fair and reasonable" requirement is applicable to an "exclusive processor," which is defined in Section 3(a)(22)(B) as an SRO or other entity that distributes the market information of an SRO on an exclusive basis. The proposed amendment would extend this requirement to non-SRO market centers when they act in functionally the same manner as exclusive processors and are the exclusive source of their own data. Applying this requirement to non-SROs is consistent with Section 11A(c)(1)(F), which grants the Commission rulemaking authority to "assure equal regulation of all markets" for NMS Securities.[301]

The Commission requests comment on the proposed authorization of independent distribution of information by market centers, and on the standards applicable to such distribution. In particular, would the authorization successfully lead to the public dissemination of more market information? If more, would the standards help to assure that the information is made available on terms that further the objectives of the NMS? Alternatively, would the standards potentially reduce the information that is disseminated?

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300 Comment also is requested on the issue of whether and, if so, on what terms Network processors should be required to disseminate non-core data on behalf of market centers. The Nasdaq UTP Plan, for example, indicates that the Network C operating committee has determined that the entity succeeding Nasdaq as processor should have the ability to disseminate the depth of book information that a participant voluntarily provides, subject to the costs of such dissemination being borne exclusively by the participant.

301 See also Section 11A(a)(1)(C) of the Exchange Act (two of the five principal objectives for the NMS are (1) the availability to broker, dealers, and investors of market information, and (2) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets.

2. Consolidation of Information

All of the SROs currently participate in Plans that provide for the dissemination of consolidated information for the NMS Stocks that they trade.[302] The Plans were adopted in order to enable the SROs to comply with Exchange Act rules regarding the reporting of trades and distribution of quotes. With respect to trades, current paragraph (b) of Rule 11Aa3-1 (proposed to be redesignated as Rule 601) requires each SRO to file transaction reporting plans that specify, among other things, how its transactions are to be consolidated with the transactions of other SROs. With respect to quotes, current paragraph (b)(1) of Rule 11Ac1-1 (proposed to be redesignated as Rule 602) requires an SRO to establish procedures for making its best quotes available to vendors.

To confirm by Exchange Act rule that both existing and any new SROs will be required to continue to participate in such joint-SRO plans, paragraph (b) of the proposed amendment to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) would require SROs to act jointly pursuant to one or more NMS plans to disseminate consolidated information for NMS Stocks. Such consolidated information must include an NBBO that is calculated in accordance with the definition set forth in proposed Rule 600.[303] In addition, the NMS plans must provide for the dissemination of all consolidated information for an individual NMS Stock through a single processor. Thus, different processors are permitted to disseminate information for different NMS Stocks (e.g., SIAC for Network A stocks, and Nasdaq for Network C stocks), but all quotes and trades in a stock must be disseminated through a single processor. As a result, information users, particularly retail investors, can obtain data from a single source that reflects

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302 See generally Advisory Committee Report, supra note 275, section III.B (description of current market data arrangements).

303 Rule 600 of proposed Regulation NMS defines "national best bid and national best offer."

the best quotes and most recent trade price for a security, no matter where such quotes and trade are displayed in the NMS. Comment is requested on these consolidation requirements.

3. Display of Consolidated Information

Paragraph (c) of the proposed amendment to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) would substantially revise the consolidated display requirement. In general, the Rule currently requires that vendors and broker-dealers, if they provide any display of market information for an NMS Stock, also must provide a consolidated display that encompasses information from all the market centers that trade the stock. The proposed amendment would retain this core requirement, but would (1) reduce the information that must be included in a consolidated display, (2) narrow the range of contexts that trigger the consolidated display requirement, and (3) generally streamline the Rule's language.

Rule 11Ac1-2 (proposed to be redesignated as Rule 603) often can require the display of a complete montage of quotes from all reporting market centers trading a security, even though the prices of some of these quotes may be far away from the current NBBO. The new definition of "consolidated display" (set forth in Rule 600 of proposed Regulation NMS) would eliminate this montage requirement and simply require a consolidated display that is limited to the prices, sizes, and market center identifications of the NBBO, along with the most recent last sale information. Beyond disclosure of this basic information, market forces, rather than regulatory requirements, would be allowed to determine what, if any, additional data from other market centers is displayed. In particular, investors and other information users ultimately could decide whether they needed additional information in their displays.

Also, Rule 11Ac1-2 (proposed to be redesignated as Rule 603) currently requires a consolidated display in a broad range of contexts. Vendors must provide a consolidated display

whenever they provide any market information to broker-dealers, and broker-dealers are prohibited from operating or maintaining a display that a vendor would not be permitted to provide. Under paragraph (c)(1) of the proposed amendment to the Rule, a consolidated display would be required only when it is most needed – a context in which a trading or order-routing decision could be implemented. For example, the consolidated display requirement would continue to cover broker-dealers who provide on-line data to their customers in software programs from which trading decisions can be implemented. Similarly, the requirement would continue to apply to vendors who provide displays that facilitate order routing by broker-dealers. It would not apply, however, when market data is provided on a purely informational website that does not offer any trading or order-routing capability.[304]

Finally, Rule 11Ac1-2 (proposed to be redesignated as Rule 603) currently imposes specific "keystroke retrieval" requirements for accessing consolidated information. The proposed amendment simply would require that consolidated data be made available in an equivalent manner as other data. In addition, the Rule contains a variety of other provisions that appear to be no longer necessary. These include requirements relating to moving tickers, categories of market information, and representative bids and offers (current paragraphs (b)(2)(iv) and (v) and paragraphs (c)(2)(iv) and (vi)). Such requirements are deleted in the proposed amendment.

The Commission requests comment on the revision of the consolidated display requirement set forth in the proposed amendment to Rule 11Ac1-2 (proposed to be redesignated

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[304] The proposed amendment would retain the exemptions currently set forth in current Rule 11Ac1-2(f) (proposed to be redesignated as Rule 603(c)(2)) for exchange and market linkage displays. The current exemption for displays used by SROs for monitoring or surveillance purposes would no longer be necessary because of the limitation of the proposed amendment to trading and order-routing contexts.

as Rule 603). Would the proposal achieve its goal of giving investors, particularly retail investors, the information they need to make informed trading decisions and to evaluate whether brokers attain best execution of their orders? Comment also is requested on whether the proposed amendment adequately identifies those contexts in which the consolidated display should apply.

F. General Request for Comment

The Commission is soliciting comment on the proposed amendments to the Plans and to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) relating to the dissemination of market data, as discussed above. Interested persons are invited to submit written presentations of views, data, and arguments concerning the proposed amendments, including the feasibility and practicality of implementing the proposed changes. Commenters are also invited to provide comments on whether the Commission should adopt an alternative model for disseminating market data to the public. Finally, the Commission requests comment on whether, if it were to adopt the proposed amendments, a phase-in period would be necessary or appropriate to allow market participants time to adapt to their provisions. If so, what aspect(s) of the proposed amendments should be phased-in, and what would be the appropriate phase-in period?

G. Paperwork Reduction Act

The proposed amendments to the Plans and to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) do not impose recordkeeping or information collection requirements, or other collections of information that require approval of the Office of Management and Budget under 44 U.S.C. 3501, et seq. Accordingly, the Paperwork Reduction Act does not apply.

H. Consideration of Costs and Benefits

1. Introduction

The Commission proposes to amend rules relating to the dissemination of market data to the public. In particular, the Commission proposes to amend three joint-industry plans – the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan -- to modify current formulas for the allocation of Plan net income to the SROs. In addition, the Commission proposes to broaden Plan governance by amending the Plans to require the establishment of a non-voting advisory committee comprised of interested parties other than SROs. The Commission also proposes to rescind the current prohibition in Rule 11Aa3-1 under the Exchange Act (proposed to be redesignated as Rule 601 of Regulation NMS)[305] on SROs and their members from independently disseminating their own trade reports. Furthermore, the Commission proposes to amend Rule 11Ac1-2 under the Exchange Act (proposed to be redesignated as Rule 603 of Regulation NMS)[306] to incorporate uniform standards pursuant to which market centers, including ATSs and market makers, that contribute to consolidated information may also independently distribute their own trade reports and quotes. The Commission further proposes to amend Rule 11Ac1-2 (proposed to be redesignated as Rule 603) to make explicit that all SROs must act jointly through the Plans and through a single processor per security to disseminate consolidated market information in NMS Stocks to the public. Finally, the Commission proposes to streamline and simplify the requirements in Rule 11Ac1-2 (proposed to be redesignated as Rule 603), including the data required to be displayed under the Rule, as well as limiting the range of the Rule to the display of market data in trading and order-routing contexts.

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305 17 CFR 240.11Aa3-1.

306 17 CFR 240.11Ac1-2.

The Commission has identified below certain costs and benefits relating to proposed amendments to the Plans and to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603). The Commission requests comments on all aspects of this cost-benefit analysis, including identification of any additional costs and/or benefits of the proposed amendments. The Commission encourages commenters to identify and supply any relevant data, analysis, and estimates concerning the costs and/or benefits of the proposed amendments.

2. Proposed New Net Income Allocation Formula

a. Benefits

The Commission preliminarily believes that modifying the current formulas for allocating distributable net income under the Plans would be beneficial to the marketplace because the new allocation formula would reward markets for the value of their quotes and would reduce the economic and regulatory distortions caused by the current formulas. Under the current formulas, the allocation of Plan net income is based on the number or share volume of an SRO's reported trades. Although quotes are disseminated by the Networks, these current trade-based formulas do not reward those market centers that generate quotes with the best prices and the largest sizes that are an important source of public price discovery. These current formulas also have encouraged certain SROs to operate as "print facilities" that award percentage rebates to ATSs and market makers that agree to report their trades through the SRO in order to obtain a larger share of market data revenues. The current formulas have resulted in some market participants distorting trade reporting to obtain more market data revenues by engaging in wash sales or by "shredding" their total trade volume into the smallest trade sizes. The Commission preliminarily believes the proposed new allocation formula would address these problems raised by the current formulas, thereby benefiting the NMS as a whole.

The proposed new allocation formula would be a two-step process. The Security Income Allocation would be the initial step of the process, when a Network's distributable net income would be allocated among the individual securities included in the Network's data stream based on the square root of the dollar volume of trading in each security. The benefit of allocating the net income in this manner is that the initial allocation would take into account the level of trading activity in each security, while adjusting for the disproportionate level of trading in the very top tier of NMS Securities.

Following the initial distribution of net income, the next step in the process would be to allocate the net income of an individual security among the SROs that trade the security based on three criteria that account for each SRO's trading and quoting activity. Specifically, fifty percent of the net income allocated to a particular security (subject to a cap of $2 per qualified transaction report) would be allocated to SROs based on their dollar volume of trading and number of qualified transactions – i.e., those transactions that have a dollar volume of $5,000 or greater. This "Trading Share" criterion is intended to reward those SROs that actively trade in the security, thereby providing liquidity and price discovery, while setting a minimum qualifying trade size to reduce the potential for shredding of trade volume. In addition, thirty-five percent of the net income allocated to a particular security would be allocated to SROs based on credits earned for the time and size of their quotes (during regular trading hours) at the NBBO. This "Quoting Share" criterion is intended to reward markets whose quotes frequently equal the best prices and for the largest sizes. Finally, fifteen percent of the net income allocated to a particular security would be allocated to SROs based on credits earned for their qualifying quotes (during regular trading hours) that improve the price of the NBBO. An SRO would earn credit for the dollar volume of its qualifying quote if the price of the quote were displayed for five seconds and

for the dollar volume of any trades reported at the price of the qualifying quote while it is displayed at the NBBO or up to five seconds after it is no longer equal to the NBBO. This "NBBO Improvement Share" criterion is intended to reward aggressive quoting that improves the NBBO price. The benefit of these broad-based measures for the allocation of net income to the SROs is that they would reward an SRO for its overall contribution of both quotes and trades, while potentially reducing the incentive for distortive trade reporting practices. In addition, investors would benefit because these broad-based measures should enhance price discovery. The Commission therefore preliminary believes that the proposed new allocation formula would be beneficial to those SROs that provide the highest quality information – that contributes to price discovery – by rewarding them with a larger portion of Plan net income.

b. Costs

The Commission recognizes that there could be potential costs associated with modifying the current formulas for allocating Plan net income. These formulas have been used since the creation of the Networks in the 1970s. The SROs and the Network processors -- SIAC and Nasdaq -- have become familiar with the formulas for purposes of allocating net income and structuring their businesses. The Network processors would need to learn the details of a new allocation formula and to consider SRO quotes, in addition to reported trades, as a measure for allocating net income.

The proposed new allocation formula is also more complex than the current formulas in the Plans. Network processors, or some other entity retained by the Networks, would be required to develop a program that would calculate the Trading Shares, Quoting Shares, and NBBO Improvement Shares of Network participants.

Finally, some SROs are likely to be allocated a smaller portion of Plan net income under the proposed new allocation formula than they would have received under the current formulas, while other SROs would receive a larger portion of net income. This would be the result if certain SROs are currently reporting a large number of trades or share volume of trades, but are not necessarily providing the best quotes or trades with larger sizes. In addition, SROs that receive a smaller portion of the net income may need to generate additional funds with which to operate and regulate their markets.

3. Plan Governance

a. Benefits

The Commission preliminarily believes that the proposed amendments to the Plans requiring the Plan participants to establish an advisory committee would enhance the NMS. Currently, a representative of each SRO participating in a Plan is a member of the operating committee that governs that Plan. The proposed amendments to the Plans would require the establishment of a non-voting advisory committee comprised solely of persons not employed by or affiliated with a Plan participant. The proposed amendments would broaden, and accordingly should improve, participation in the governance of the Plans.

The proposed amendments would require the Plan participants to select the members of the advisory committee comprised, at a minimum, of one or more representatives associated with (1) a broker-dealer with a substantial retail investor base, (2) a broker-dealer with a substantial institutional investor customer base, (3) an ATS, (4) a data vendor, and (5) an investor. In addition, each Plan participant would be entitled to select an additional committee member. The Commission preliminarily believes that the composition of the advisory committee should give interested parties other than the SROs a voice in matters that affect them. These members of the

advisory committee would have the right to submit their views to the operating committee on Plan business (other than matters determined to be confidential by a majority of Plan participants), prior to any decision made by the operating committee, and would have the right to attend operating committee meetings. Broader participation in the Plans through the establishment of an advisory committee would be beneficial to the administration of the Plans because it could promote the formation of industry consensus on disputed issues.

b. Costs

The proposed amendments to the Plans could potentially result in costs to the Plan participants. Participants would be required to engage in a selection process for purposes of establishing an advisory committee. A Plan's operating committee as a whole would be required to select a minimum of five committee members. Each Plan participant would then have the right to select one committee member. This selection process could potentially result in added costs and administrative burden and expense to the Plan participants.

Another potential cost of the proposed Plan amendment requiring the establishment of an advisory committee could be disruption of the current governance of the Plans by their participants. Since the creation of the Plans, representatives from the SROs have been the sole participants in the Plans and have been responsible for their administration. The additional participation of non-SRO parties could increase the difficulty of reaching consensus on Plan business.

4. Proposed Amendments to Rules 11Aa3-1 and 11Ac1-2

a. Independent Distribution of Information

i. Benefits

The Commission proposes to amend Rule 11Aa1-3 (proposed to be redesignated as Rule 601) to rescind the prohibition on SROs and their members from distributing their own transaction reports and last sale data outside of the Plans.[307] Rescission of this prohibition would allow market centers, including ATSs and market makers, that contribute to consolidated information to also distribute their market data independently of the Networks. In addition to the data that market centers are required to provide to the Networks, the rescission would allow market centers to independently distribute other market data, such as depth of the limit order book. Such information could be beneficial to investors and other information users because it has become increasingly important as decimal trading has spread displayed depth across a greater number of price points. Market centers may also benefit from additional revenues if they chose to charge a fee for the independent distribution of their market data information.

The Commission also proposes to add new provisions to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) to establish uniform standards for the distribution of market data. Uniform standards would be beneficial to the marketplace because they would create an equivalent regulatory regime for all types of market centers. The proposed standards would require an exclusive processor, or a broker or dealer with respect to information for which it is the exclusive source, that distributes quote and transaction information in an NMS Stock to a securities information processor ("SIP") to do so on terms that are fair and reasonable. In addition, those SROs, brokers, or dealers that distribute such information to a SIP, broker, dealer, or other persons would be required to do so on terms that are not unreasonably discriminatory. Furthermore, these proposed uniform standards are based, in part, on similar requirements found

[307] Although current rules do not also prohibit the independent distribution of quotation information, the rules do not provide standards for such distribution.

in Sections 3 and 11A of the Exchange Act[308] for SROs and entities that distribute SRO information on an exclusive basis. The Commission preliminarily believes that extending these requirements to non-SRO market centers, including ATSs and market makers, would help assure equal regulation of all markets that trade NMS Stocks.

ii. Costs

The Commission recognizes that the proposed rescission of the prohibition on independent distribution of trade reports under Rule 11Aa3-1 (proposed to be redesignated as Rule 601) could potentially lead to market centers incurring costs associated with the independent distribution of their market data if they choose to distribute such data without charging a fee. In addition, investors may have to pay for additional data if market centers choose to charge a fee for the additional data. Furthermore, if market centers choose to distribute their own quotation information, this could potentially result in one market center's data becoming more or less valuable than another market center's data, and thereby increase or reduce that market center's overall income.

b. Consolidation of Information

i. Benefits

The Commission proposes to amend Rule 11Ac1-2 (proposed to be redesignated as Rule 603) to make explicit that all SROs must act jointly through the Plans to disseminate consolidated market information, including an NBBO, in NMS Stocks to the public. All SROs currently participate in Plans that provide for the dissemination of consolidated transaction and quotation information for the NMS Stocks that they trade. The proposed amendment to the Rule would provide the benefit of clarifying that all SROs – whether existing or new – would be

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[308] 15 U.S.C. 78c and 15 U.S.C. 78k-1.

required to participate jointly in one or more Plans to disseminate consolidated information in NMS Stocks. The proposed amendment would also require that all quote and trade information for an individual NMS Stock be disseminated through a single processor (currently, SIAC or Nasdaq). The Commission preliminarily believes that requiring a single processor for a particular security should help to ensure that investors continue to receive the benefits of obtaining consolidated information from a single source.

ii. Costs

The Commission does not foresee any costs associated with this particular proposed amendment to Rule 11Ac1-2 (proposed to be redesignated as Rule 603), and, specifically, requests comment on whether amending the Rule to require explicitly what is current practice among the SROs regarding the consolidated dissemination of information through the Plans and through a single processor would result in any costs or burdens on the SROs or on any other entities.

c. Display of Consolidated Information

i. Benefits

The Commission proposes to amend Rule 11Ac1-2 (proposed to be redesignated as Rule 603) in order to streamline the current requirements and to ease the burden of compliance. Currently, the Rule requires data vendors and broker-dealers that provide any display of market data in a particular security to provide a consolidated display of data from all of the market centers that trade the security. The Commission proposes to retain this core requirement, but proposes to streamline the data required to be displayed, reduce the range of the contexts in which the Rule would apply, and amend the Rule's language to clarify certain provisions and to rescind unnecessary provisions.

In particular, the Commission proposes to limit the scope of the consolidated display requirement. The proposed amendment to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) would eliminate the burden on vendors and broker-dealers to display a complete montage of quotes from all market centers trading a particular security, which would include the price of quotes that may be far away from the current NBBO. Vendors and broker-dealers would therefore benefit from this reduced consolidated display requirement. Furthermore, they, as well as other persons (including investors and other information users), would have the ability to decide what, if any, additional data from other market centers beyond this basic disclosure to display.

The Commission also proposes to amend the Rule to limit the consolidated display requirement to market data provided in a context in which a trading or order-routing decision could be implemented. Currently, the Rule applies broadly to any displays of market data provided by a vendor to a broker-dealer and to any displays of market data provided by a broker-dealer. This proposed amendment to the Rule would allow vendors and broker-dealers to display market data without having to comply with the consolidated display requirement so long as they are not displaying it in a trading or order routing context. For example, under the proposed amendment, if market data is provided on a purely informational website and does not offer any trading or order-routing capabilities, then the vendor displaying such data would not be required to comply with the consolidated display requirement for purposes of displaying that data. Vendors and broker-dealers would benefit from a reduction in their consolidated display obligations under this proposed amendment, while still providing investors with useful information.

The Commission also proposes to amend Rule 11Ac1-2 (proposed to be redesignated as Rule 603) to simply the rule language to require that consolidated data be made available in an equivalent manner as other data and to rescind unnecessary provisions in order to update the Rule.[309] Together, these proposed amendments should benefit broker-dealers and vendors by making compliance with the Rule easier and more efficient.

ii. Costs

A potential cost attributable to the proposed amendment to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) could be that there may be individuals who use the displayed montage of quotes from all market centers trading a particular security. If the proposed amendment were adopted, and vendors and broker-dealers determined not to display this additional information, these investors would be required to obtain the additional data at additional cost.

The proposed amendment to the Rule could also potentially result in an administrative cost or burden for vendors and broker-dealers that would be required to assess in what circumstances they are displaying market data information for trading and order-routing purposes and in what circumstances they are displaying such information for other purposes. The Commission preliminarily believes that such a cost would be minimal.

I. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act[310] requires the Commission, whenever it engages in rulemaking, and is required to consider or determine if an action is necessary or appropriate in the public interest, also to consider whether the action will promote efficiency, competition, and

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309 The provisions to be rescinded would include requirements relating to moving tickers, categories of market information, and representative bids and offers.

310 15 U.S.C. 78c(f).

capital formation. Section 23(a)(2) of the Exchange Act[311] requires the Commission, in adopting rules under the Exchange Act, to consider the impact that any such rule would have on competition. Section 23(a)(2) of the Exchange Act prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The proposed amendments to the Plans to implement a new net income allocation formula should help to promote efficiency in the marketplace by eliminating incentives for market participants to distort trade reporting under the current formulas by engaging in wash trades and by eliminating incentives for market participants to "shred" their total trade volume in order to obtain market data revenues. In addition, the proposed amendments to the Plans to establish an advisory committee should promote efficiency in the administration of the Plans by allowing interested parties other than SROs to have a voice in the governance of such Plans, which could contribute to the resolution of potential disputes that the Plan participants would otherwise bring before the Commission. Furthermore, the proposed amendments to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) should promote efficiency and competition among market centers by helping to assure that independently reported trade and quote information is distributed on terms that are fair and reasonable and not unreasonably discriminatory. The proposed amendment to amend Rule 11Ac1-2 (proposed to be redesignated as Rule 603) should also promote efficiency in the dissemination of consolidated market information by requiring that all SROs act jointly through the Plans to disseminate such information to the public.

The proposed amendments to the Plans to modify the current net income allocation formulas and to establish an advisory committee should assist capital formation through a more

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[311] 15 U.S.C. 78w(a)(2).

appropriate allocation of the Networks' net income to those who contribute most to public price discovery, and by potentially minimizing costs that may arise from having to resolve disputes relating to the administration of the Plans through broader representation. The proposed amendments to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) would also eliminate the requirement to display a complete montage of quotes from all market centers and should therefore promote capital formation by reducing the costs to vendors and broker-dealers that are currently required to display quotes that may be far away from the NBBO.

The Commission preliminarily believes that the proposed amendments to the Plans and to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) would not impose any competitive burden that is not necessary and appropriate in furtherance of the purposes of the Exchange Act. In fact, the proposed new allocation formula should provide for a more useful distribution of net income by rewarding market centers for the quality of their quotes in addition to their reported trades. The proposed amendments to the Plans to establish an advisory committee should also enhance and promote competition by broadening governance of the Plans to include other non-SRO parties. Furthermore, the proposed amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) should lessen the burden on vendors and broker-dealers from having to comply with certain consolidated display requirements, and should engender competition among market centers that contribute to consolidated information that also choose to independently distribute their own market data. In addition, the proposed amendment providing that all SROs consolidate information in each NMS Stock and disseminate such information through a single processor per security should clarify that SROs are on an equal competitive footing with each other. Thus, the Commission

preliminarily believes that the proposed amendments should enhance rather than burden competition by creating a more equal competitive environment for market centers and others.

The Commission requests comment on the proposed amendments' effects on the economy as a whole, and more specifically, how the proposed amendments to the Plans and to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) are expected to affect efficiency, competition, and capital formation. The Commission requests that, if possible, commenters provide empirical data as well as factual support for their views.

J. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[312] the Commission must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effect on competition, investment or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. The Commission requests comment on the potential impact of the proposed amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

K. Regulatory Flexibility Act Certification and Initial Regulatory Flexibility Analysis

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312 Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

1. Regulatory Flexibility Act Certification for the Proposed Amendments to the Plans

The Commission hereby certifies, pursuant to 5 U.S.C. 603(b), that the proposed amendments to the Plans, if adopted, would not have a significant economic impact on a substantial number of small entities. The proposed amendments to the Plans imposing a new net income allocation formula would only impact the SROs,[313] SIAC (the processor for the CTA Plans and the CQ Plan), and Nasdaq (the processor for the Nasdaq UTP Plan). The proposed amendments to the Plans requiring the establishment of an advisory committee would apply only to Plan participants. SIAC and Nasdaq would not be considered "small entities" for purposes of the Regulatory Flexibility Act.[314] The Plan participants are either national securities exchanges or a national securities association and, as such, are not small entities.[315] Accordingly, the Commission does not believe that the proposed amendments to the Plans would have a significant economic impact on a substantial number of small entities.

The Commission encourages written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

2. Initial Regulatory Flexibility Analysis for Proposed Amendments to Rules 11Aa3-1 and 11Ac1-2

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313 Paragraph (e) of Exchange Act Rule 0-10 provides that the term "small entity," when referring to an exchange, means any exchange that has been exempted from the reporting requirements of 17 CFR 240.11Aa3-1 and is not affiliated with any person that is not a small entity. Under this standard, none of the exchanges affected by the proposed rule is a small entity. Similarly, the national securities association affected by the proposed rule is not small entity as defined by 13 CFR 121.201.

314 See 17 CFR 240.0-10(g).

315 See 17 CFR 240.0-10(e).

This Initial Regulatory Flexibility Act Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to the proposed amendment to Rules 11Aa3-1 and 11Ac1-2 under the Exchange Act (proposed to be redesignated as Rules 601 and 603 of Regulation NMS).[316]

a. Reasons for the Proposed Action

The Commission believes that an overall modernization of the rules for disseminating market data to the public is necessary to address problems posed by the current market data rules. The Commission proposes to retain the core elements of the current rules – price discovery and mandatory consolidation – which provide important benefits to investors and to others who use market information, while amending other parts of the current rules that have resulted in serious economic and regulatory distortions. More specifically, the Commission proposes to amend the Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) to lift certain restrictions in order to reduce the burden on and to provide simplification and uniformity for those market centers, broker-dealers, and data vendors that have to comply with requirements under the Rules.

b. Objectives

The proposed amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) are designed to fulfill several objectives. First, the proposed amendment to Rule 11Aa3-1 (proposed to be redesignated as Rule 601) is intended to provide market centers, including ATSs and market makers, with flexibility to independently distribute their own trade reports, aside from their obligation to provide their trade reports to an SRO or to the Networks (depending on the type of market center). Second, a prime objective of the proposed amendments to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) is to provide uniform

[316] 17 CFR 240.11Aa3-1 and 17 CFR 240.11Ac1-2.

standards for all market centers, including non-SRO market centers and entities that are exclusive processors of SRO market data, for the independent distribution of market data. Third, the objective of the proposed amendment to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) providing that all SROs act jointly through the Plans and disseminate their consolidated information through a single processor is to clarify the current practice among the SROs and to require continued participation in the Plans and dissemination through one processor per security. Fourth, an additional objective of the proposed amendments to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) is to reduce consolidated display requirements on broker-dealers and vendors and to limit their consolidated display obligations to the disclosure of the NBBO and consolidated last sale information, and to the display of market information in a trading or order-routing context. Finally, the proposed amendments to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) are intended to ease the burden of compliance by simplifying the current consolidated display requirements under the Rule and by rescinding old provisions in the Rule that are outdated and no longer necessary.

c. Legal Basis

The Commission proposes amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) pursuant to its authority set forth in Sections 2, 3(b), 5, 6, 11A, 15, 15A, 17(a), 19, 23(a), and 36 of the Exchange Act, and Rules 11Aa3-2(b)(2) and 11Aa3-2(c)(1) thereunder.[317]

d. Small Entities Subject to the Rule

The proposed amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) would affect ATSs, market makers, broker-dealers, and SIPs that could

[317] 15 U.S.C. 78b, 78c(b), 78e, 78f, 78k-1, 78o, 78o-3, 78q(a), 78s; 78w(a), and 78mm; 17 CFR 240.11Aa3-2(b)(2) and 17 CFR 240.11Aa3-2(c)(1).

potentially be small entities. Paragraph (c) of Rule 0-10 under the Exchange Act[318] defines the term "small business" or "small organization," when referring to a broker-dealer, to mean a broker or dealer that had total capital of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, or if not required to file such statements, it had total capital of less than $500,000 on the last business day of the preceding fiscal year; and is not affiliated with any person (other than a natural person) that is not a small business or small organization. ATSs and market makers would be considered broker-dealers for purposes of this definition. Paragraph (g) of Rule 0-10[319] defines the term "small business" or "small organization," when referring to a SIP, to mean a SIP that had gross revenues of less than $10 million during the preceding fiscal year and provided service to fewer than 100 interrogation devices or moving tickers at all times during the preceding fiscal year; and is not affiliated with any person (other than a natural person) that is not a small business or small organization.

As of December 31, 2002, the Commission estimates that there are approximately 880 registered broker-dealers, including ATSs and market makers, and approximately 16 SIPs that would be considered small entities. The Commission's proposed amendment to Rule 11Aa3-1 (proposed to be redesignated as Rule 601) would enable small market centers, including ATSs and market makers, that contribute to consolidated information, if they so choose, to also independently distribute their own trade reports. The Commission's proposed amendment to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) would reduce the compliance burden on

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318 17 CFR 240.0-10(c).

319 17 CFR 240.0-10(g).

small broker-dealers and SIPs by limiting the data required to be consolidated and displayed under the Rule.[320]

The Commission requests comment on the number of small entities that would be impacted by the proposed amendments, including any available empirical data.

e. Reporting, Recordkeeping and Other Compliance Requirements

The proposed amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) would not impose any new reporting, recordkeeping or other compliance requirements on ATSs, market makers, broker-dealers, and SIPs that are small entities. SROs that would be subject to these proposed amendments would not be considered small entities.

f. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap or conflict with the proposed amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603).

g. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, the Commission has considered the following alternative models for disseminating market data to the public: (1) a competing consolidators model under which each SRO would be allowed to sell its market data separately to any number of consolidators; (2) a rescission of the consolidated display

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320 The proposed amendment to Rule 11Ac1-2 (proposed to be redesignated as Rule 603), providing that all SROs act jointly through the Plans and disseminate their consolidated information through a single processor would only apply to the SROs, which are not "small entities" for purposes of the Regulatory Flexibility Act.

requirement and allowing all SROs and other market centers to distribute their market data individually; and (3) a hybrid model that would retain the consolidated display requirement and existing Networks solely for the dissemination of the NBBO, but allow the SROs to distribute their own quotes and trades independently and without a consolidated display requirement. These alternative models were all intended to introduce more competition in the marketplace and greater flexibility in market data dissemination.

The primary goal of the proposed amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) is to retain the benefits of the consolidated display requirement, which provides a uniform, consolidated stream of data and is the single most important tool for unifying all of the market centers trading NMS Stocks, while providing market centers that contribute to consolidated information with the ability to independently distribute their own market data and reducing the consolidated display requirements on broker-dealers and SIPs. The Commission preliminarily believes that these potential alternative models pose an unacceptable risk of losing important benefits that investors and other information users receive under the current system – an affordable and highly reliable stream of quotes and trades that is consolidated from all significant market centers trading an NMS Stock. The Commission also does not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed amendments as the amendments already propose performance standards and do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed amendments.

h. Solicitation of Comments

The Commission encourages comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, the Commission requests comments regarding: (1) the number of small entities that may be affected by the proposed amendments; (2) the existence or nature of the potential impact of the proposed amendments on small entities discussed in the analysis; and (3) how to quantify the impact of the proposed amendments. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposals are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

VII. Regulation NMS Proposal

A. Introduction

The Commission proposes to simplify the structure of the rules adopted under Section 11A of the Exchange Act ("NMS rules") by designating them as proposed Regulation NMS and renumbering them. In addition, the Commission proposes to include in proposed Regulation NMS proposed Rule 600 ("NMS Security Designation and Definitions"). This proposed new rule would replace Exchange Act Rule 11Aa2-1, which designates "reported securities" as NMS securities. Proposed Rule 600 also would include, in alphabetical order, all of the defined terms used in proposed Regulation NMS. The proposed new rule series is Rule 600 through Rule 612 (17 CFR 242.600 – 612).

Proposed Rule 600 would provide a single set of definitions that would be used throughout proposed Regulation NMS. To create a single set of definitions, the Commission proposes to update or delete from proposed Regulation NMS some terms that have become obsolete and to eliminate the use of multiple, inconsistent definitions for identical terms. In

addition, the Commission is proposing to adopt two new terms, "NMS security" and "NMS stock," which would replace some terms that would be eliminated. These terms are necessary to maintain distinctions between current NMS rules that apply to equity securities and ETFs only (e.g., Exchange Act Rules 11Ac1-4 and 11Ac1-5) and those that apply to equity securities, ETFs, and options (e.g., Exchange Act Rules 11Ac1-1 and 11Ac1-6). Proposed Rule 600 would retain, unchanged, most definitions used in the current NMS rules and would include new definitions used in the new rules proposed in this release. The proposed definitional changes would not affect the substantive requirements of the existing NMS rules.

B. Discussion of Proposed Regulation NMS

1. Rule Numbering

In proposed Regulation NMS, the Commission would renumber and, in some cases, rename the current NMS rules, and incorporate proposed Rule 600 and the proposed new rules. Where applicable, current NMS rules would be amended to remove the definitions which would be consolidated in proposed Rule 600. The proposed titles and numbering of the rules in proposed Regulation NMS, including the proposed new rules, appear below:

- Rule 600: NMS Security Designation and Definitions (replaces Exchange Act Rule 11Aa2-1, which the Commission is proposing to rescind, and incorporates definitions from the current NMS rules and the proposed new rules);
- Rule 601: Dissemination of Transaction Reports and Last Sale Data with Respect to Transactions in NMS Stocks (renumbers and renames Exchange Act Rule 11Aa3-1, the substance of which would be modified);[321]

[321] In the market data proposal, discussed in Section VI., the Commission is proposing to amend substantively Exchange Act Rule 11Aa3-1.

- Rule 602: Dissemination of Quotations in NMS Securities (renumbers and renames Exchange Act Rule 11Ac1-1 ("Quote Rule"), the substance of which would remain largely intact);
- Rule 603: Distribution, Consolidation, and Display of Information with Respect to Quotations for and Transactions in NMS Stocks (renumbers and renames Exchange Act Rule 11Ac1-2 ("Vendor Display Rule"), the substance of which would be modified substantially);[322]
- Rule 604: Display of Customer Limit Orders (renumbers Exchange Act Rule 11Ac1-4 ("Limit Order Display Rule"), the substance of which would remain largely intact);
- Rule 605: Disclosure of Order Execution Information (renumbers Exchange Act Rule 11Ac1-5, the substance of which would remain largely intact);
- Rule 606: Disclosure of Order Routing Information (renumbers Exchange Act Rule 11Ac1-6, the substance of which would remain largely intact);
- Rule 607: Customer Account Statements (renumbers Exchange Act Rule 11Ac1-3, the substance of which would remain largely intact);
- Rule 608: Filing and Amendment of National Market System Plans (renumbers Exchange Act Rule 11Aa3-2, the substance of which would remain largely intact);
- Rule 609: Registration of Securities Information Processors: Form of Application and Amendments (renumbers Exchange Act Rule 11Ab2-1, the substance of which would remain largely intact);
- Rule 610: Access to Published Bids and Offers (proposed new rule);

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322 In the market data proposal, discussed in Section VI., the Commission is proposing to amend substantively Exchange Act Rule 11Ac1-2.

- Rule 611: Trade-Through Rule (proposed new rule); and
- Rule 612: Minimum Pricing Increment (proposed new rule).

2. Rule 600 -- NMS Security Designation and Definitions

a. Transaction Reporting Requirements for Equities and Listed Options

Section 11A(a)(2) of the Exchange Act directs the Commission to "designate the securities or classes of securities qualified for trading in the national market system."[323] The 1975 Amendments and the legislative history to the 1975 Amendments were silent as to the particular standards the Commission should employ in designating NMS securities.[324] Instead, Congress provided the Commission with the flexibility and discretion to base NMS designation standards on the Commission's experience in facilitating the development of an NMS.[325]

To satisfy the requirement that it designate the securities qualified for trading in the NMS, the Commission adopted Exchange Act Rule 11Aa2-1 in 1981.[326] Exchange Act Rule 11Aa2-1 currently defines the term "national market system security" to mean "any reported security as defined in Rule 11Aa3-1." Exchange Act Rule 11Aa3-1 defines a "reported security" as "any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan."[327] Exchange Act Rule

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323 15 USC 78k-1(a)(2).

324 See Securities Exchange Act Release No. 23817 (November 17, 1986), 51 FR 42856 (November 26, 1986) (proposing amendments to Exchange Act Rules 11Aa2-1 and 11Aa3-1) ("1986 Proposing Release").

325 See id.

326 See Securities Exchange Act Release No. 17549 (February 17, 1981), 46 FR 13992 (February 25, 1981) (adopting Exchange Act Rule 11Aa2-1).

327 See Exchange Act Rule 11Aa3-1(a)(4).

11Aa3-1(a)(3) defines the term "effective transaction reporting plan" to mean "any transaction reporting plan approved by the Commission pursuant to this section." Exchange Act Rule 11Aa3-1(a)(2) defines the term "transaction reporting plan" to mean "any plan for collecting, processing, making available or disseminating transaction reports with respect to transactions in reported securities filed with the Commission pursuant to, and meeting the requirements of, this section." The effective transaction reporting plans are the CTA Plan and the Nasdaq UTP Plan.

In addition to identifying those securities deemed to be NMS securities, when adopted, the Exchange Act Rule 11Aa2-1 designation also tacitly identified those securities that did not meet that designation (i.e., securities other than those that are so designated as NMS securities). Historically, securities excluded from this designation included standardized options and small capitalization equity securities (a subset of which has been identified as Nasdaq SmallCap securities). Trading in options and Nasdaq SmallCap securities has increased over the past three decades and gradually many of the rules that govern NMS securities have been applied to these securities. Over time, much of the terminology that has been used to distinguish NMS securities from options and Nasdaq SmallCap securities has become obsolete or contorted.

For example, the Nasdaq UTP Plan provides for the collection from Plan participants, and the consolidation and dissemination to vendors, subscribers and others, of quotation and transaction information in "eligible securities." Prior to 2001, the Nasdaq UTP Plan defined an "eligible security" as any Nasdaq National Market security as to which unlisted trading privileges have been granted to a national securities exchange pursuant to Section 12(f) of the Exchange Act or that is listed on a national securities exchange. In 2001, the Nasdaq UTP Plan

was amended to include Nasdaq SmallCap securities.[328] As a result, Nasdaq SmallCap securities became eligible securities because they are now reported through an effective transaction reporting plan (i.e., the Nasdaq UTP Plan), bringing them within the purview of the NMS security designation. Several definitions in the current NMS rules, however, do not reflect the inclusion of Nasdaq SmallCap securities in the Nasdaq UTP Plan and therefore must be updated. Regulation NMS proposes to do so.

In addition, transactions in exchange-listed options are reported through the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information ("OPRA Plan").[329] Unlike the CTA Plan and the Nasdaq UTP Plan-- transaction reporting plans that the Commission approved pursuant to Exchange Act Rules 11Aa3-1 and 11Aa3-2-- the OPRA Plan was approved by the Commission only pursuant to Exchange Act Rule 11Aa3-2.[330] As such, the OPRA Plan is an "effective national market system plan" but not an "effective transaction reporting plan." While at their core the CTA Plan, the Nasdaq UTP Plan, and the OPRA Plan perform essentially the same function (i.e., they govern the consolidated reporting of securities transactions by Plan participants), because the OPRA Plan is not an effective transaction reporting plan, listed options covered by the OPRA Plan are technically not "securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan." Therefore, options were not considered NMS securities as defined by

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328 See Securities Exchange Act Release No. 45081 (November 19, 2001), 66 FR 59273 (November 27, 2001).

329 The exchanges that are participants to the OPRA Plan are Amex, BSE, CBOE, ISE, PCX, and Phlx.

330 See Securities Exchange Act Release No. 17638 (March 18, 1981), 22 S.E.C. Docket 484 (March 31, 1981). Exchange Act Rule 11Aa3-2 codifies the procedures that SROs must follow to seek approval for or amendment of a national market system plan.

Exchange Act Rule 11Aa2-1. While the impact of this distinction may not be readily apparent, the differences in the way the Plans are designated dictates the securities laws and regulations that apply to securities reported pursuant to those Plans.

Further, as discussed below, some terms in the NMS rules have become superfluous or outdated. In addition, in the current NMS rules, certain terms are defined in different ways in different rules. Because proposed Regulation NMS proposes a consolidated set of definitions that would apply to all rules within the proposed Regulation, these inconsistencies would need to be eliminated. The definitional changes proposed in this Release, however, are not intended to change materially the scope of the current NMS rules.

b. "NMS security" and "NMS stock"

Some NMS rules, including the Quote Rule and Exchange Act Rule 11Ac1-6, currently apply to both (1) equities, ETFs and related securities for which transaction reports are made available pursuant to an effective transaction reporting plan, and (2) listed options for which market information is made available pursuant to an effective national market system plan. To provide a single term that would be used in any provision of proposed Regulation NMS that applies to both categories of securities, the Commission is proposing to adopt a new term, "NMS security."[331]

Because many rules in proposed Regulation NMS, including Rule 604 (currently Exchange Act Rule 11Ac1-4) and Rule 605 (currently Exchange Act Rule 11Ac1-5), would

[331] Specifically, the Commission proposes to define an "NMS security" as "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." This definition currently is used to define a "reported security" in the Quote Rule. See Exchange Act Rule 11Ac1-1(a)(20). For the reasons described below, the Commission is proposing to eliminate the term "reported security" from the Quote Rule and not include it in proposed Regulation NMS.

continue to be inapplicable to listed options, the Commission proposes to adopt a new term, "NMS stock" that would be used in those provisions. The Commission proposes to define the term "NMS stock" as "any NMS security other than an option."

c. Changes to Current Definitions in the NMS Rules

Proposed Rule 600 would provide a single set of definitions that would be used throughout proposed Regulation NMS. To create a single set of definitions, the Commission proposes to eliminate multiple, inconsistent definitions of identical terms. In addition, the Commission proposes to amend some definitions in the NMS rules to reflect changed conditions in the marketplace or to modernize references. For example, as discussed above, several definitions in the NMS rules have become obsolete by the extension of the Nasdaq UTP Plan to Nasdaq SmallCap securities.[332] Because the Nasdaq UTP Plan includes Nasdaq SmallCap securities, those securities now are "securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan" (i.e., they are "reported" securities).[333] For this reason, it is no longer necessary to distinguish, as several NMS rules do currently, between "reported" securities and equity securities for which market

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[332] See NASD Rule 4200 for the definition of a Nasdaq SmallCap security. The Nasdaq UTP Plan provides for the collection from Plan participants, and the consolidation and dissemination to vendors, subscribers and others, of quotation and transaction information in "eligible securities." "Eligible securities" initially included Nasdaq NMS securities listed on an exchange or traded on an exchange pursuant to a grant of unlisted trading privileges. See Securities Exchange Act Release No. 28146 (June 26, 1990), 55 FR 27917 (July 6, 1990) (order approving the Nasdaq UTP Plan on a pilot basis). In 2001, the Nasdaq UTP Plan was amended to, among other things, revise the definition of "eligible securities" to include Nasdaq SmallCap securities. See Securities Exchange Act Release No. 45081 (November 19, 2001), 66 FR 49273 (November 27, 2001) (order approving Amendment No. 12 to the Nasdaq UTP Plan).

[333] Exchange Act Rules 11Aa3-1 and 11Ac1-2 define the term "reported security" to mean "any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan." As discussed more fully below, the Quote Rule provides a different definition of "reported security."

information is made available through Nasdaq.[334] Accordingly, the Commission proposes to eliminate or revise the defined terms in the NMS rules that make this distinction.

i. "Covered security"

Different definitions of the term "covered security" appear in the Quote Rule, the Limit Order Display Rule, and in Exchange Act Rule 11Ac1-6.[335] In addition, as discussed below, the term has become obsolete. Therefore, the Commission is proposing to eliminate the term "covered security" from proposed Regulation NMS and to replace it with the term "NMS security" or "NMS stock," as applicable, depending upon the scope of the particular rule.

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334 See e.g., Exchange Act Rule 11Ac1-2(a)(4) (defining "subject security" to mean "(i) any reported security; and (ii) any other equity security as to which transaction reports, last sale data or quotation information is disseminated through NASDAQ"); and Exchange Act Rule 11Ac1-1(a)(6) (defining "covered security" to mean "any reported security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii))").

335 Although the Quote Rule and the Limit Order Display Rule each define the term "covered security" as "any reported security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii))," the scope of the definitions is not identical because each rule defines the term "reported security" differently. The Quote Rule defines a "reported security" to mean "any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." See Exchange Act Rule 11Ac1-1(a)(20). The Limit Order Display Rule defines a "reported security" to mean "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan." See Exchange Act Rule 11Ac1-4(a)(10).

Exchange Act Rule 11Ac1-6 defines the term "covered security" to mean: "(i) any national market system security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as defined in Section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii)); and (ii) any option contract traded on a national securities exchange for which last sale reports and quotation information are made available pursuant to an effective national market system plan. See Exchange Act Rule 11Ac1-6(a)(1)."

ii. "Reported security"

Several NMS rules use the term "reported security." Although the Limit Order Display Rule, the Vendor Display Rule, and Exchange Act Rule 11Aa3-1 contain identical definitions of "reported security," the Quote Rule provides a different definition.[336] Because the term "reported security" is defined inconsistently in the NMS rules and in light of proposed changes to related terms, the Commission proposes to eliminate the term "reported security" from proposed Regulation NMS and replace it with the term "NMS security" or "NMS stock," depending on the scope of the particular rule.

The Limit Order Display Rule uses the term "reported security" solely for the purpose of defining the term "covered security."[337] Because the Commission proposes to eliminate the term "covered security," the term "reported security" also would not need to be used in the redesignated Limit Order Display Rule (proposed Rule 604). Therefore, as noted above, the term "NMS stock" would replace the term "covered security" in proposed Rule 604.

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336 The Limit Order Display Rule, the Vendor Display Rule, and Exchange Act Rule 11Aa3-1 define a "reported security" to mean "any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan." See Exchange Act Rules 11Ac1-4(a)(10), 11Ac1-2(a)(20), and 11Aa3-1(a)(4). The Quote Rule defines the term "reported security" to mean "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." See Exchange Act Rule 11Ac1-1(a)(20). As discussed above, the Commission is proposing substantial modifications to the current Vendor Display Rule.

337 See Exchange Act Rule 11Ac1-4(a)(5). The Limit Order Display Rule defines a "covered security" to include both reported securities and other securities for which market information is disseminated through Nasdaq.

Similarly, the Quote Rule uses the term "reported security" primarily to define the term "covered security."[338] Because the Commission proposes to eliminate the term "covered security," the term "reported security" also would not be used in the redesignated Quote Rule (proposed Rule 602).[339]

iii. "Subject security"

The Quote Rule and the Vendor Display Rule use the term "subject security," although the rules define the term differently. To eliminate this inconsistency, the Commission proposes not to use the term "subject security" in the proposed successor to the Vendor Display Rule (proposed Rule 603), and to retain for the Quote Rule provision of proposed Regulation NMS (proposed Rule 602) a slightly modified version of the definition of "subject security" that is currently in the Quote Rule.

The Vendor Display Rule defines the term "subject security" to mean "(i) any reported security; and (ii) any other equity security as to which transaction reports, last sale data or quotation information is disseminated through NASDAQ."[340] As discussed above, the extension of the Nasdaq UTP Plan to include Nasdaq SmallCap securities renders obsolete the distinction between a "reported security" and a security for which market information is disseminated through Nasdaq. Accordingly, the Commission proposes to use the term "NMS stock" rather than "subject security" in the proposed Vendor Display Rule successor.

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338 See Exchange Act Rule 11Aa1-1(a)(6). The Quote Rule defines a "covered security" to include both reported securities and other securities for which market information is disseminated through Nasdaq.

339 In paragraph (b)(1)(ii) of the Quote Rule, which requires a registered national securities association to disseminate quotations at all times when last sale information is available with respect to "reported securities," the reference to "reported security" would be replaced by a reference to "NMS security."

340 See Exchange Act Rule 11Ac1-2(a)(4).

The Quote Rule currently defines the term "subject security" to mean:

> (i) With respect to an exchange: (A) Any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as **reported in the consolidated system**; and (B) Any other **covered security** for which such exchange has in effect an election, pursuant to paragraph (b)(5)(i) of this section, to collect, process, and make available to quotation vendors bids, offers, quotation sizes, and aggregate quotation sizes communicated on such exchange; and
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> (ii) With respect to a member of an association: (A) Any exchange-traded security for which such member acts in the capacity of an OTC market maker unless the executed volume of such member, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as **reported in the consolidated system**; and (B) Any other **covered security** for which such member acts in the capacity of an OTC market maker and has in effect an election, pursuant to paragraph (b)(5)(ii) of this section, to communicate to its association bids, offers and quotation sizes for the purpose of making such bids, offers and quotation sizes available to quotation vendors.[341]

Because the Quote Rule applies to both listed options and equities covered by an effective transaction reporting plan, the Commission proposes to revise the Quote Rule's definition of "subject security" by replacing references to a "covered security" with references to an "NMS security." In addition, for the reasons discussed below, the Commission proposes to replace the phrase "reported in the consolidated system" with the phrase "reported pursuant to an effective transaction reporting plan or effective national market system plan."

iv. "Consolidated system"

Paragraph (a)(25) of the Quote Rule currently defines the term "subject security" to include, among other things: (1) with respect to an exchange, any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as

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[341] See Exchange Act Rule 11Ac1-1(a)(25) (emphasis added).

reported in the consolidated system; and (2) with respect to a member of an association, any exchange-traded security for which such member acts in the capacity of an OTC market maker unless the executed volume of such member, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system. Paragraph (a)(5) of the Quote Rule defines the term "consolidated system" to mean "the consolidated transaction reporting system, including a transaction reporting system operating pursuant to an effective national market system plan."

The Commission proposes to clarify the definition of "subject security" by eliminating the phrase "reported in the consolidated system" from proposed Regulation NMS and replacing it with the phrase "reported pursuant to an effective transaction reporting plan or an effective national market system plan." Thus, proposed Regulation NMS would define a "subject security" to include, among other things: (1) with respect to a national securities exchange, any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported pursuant to an effective transaction reporting plan or effective national market system plan; and (2) with respect to a member of a national securities association, any exchange-traded security for which such member acts in the capacity of an OTC market maker unless the executed volume of such member, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported pursuant to an effective transaction reporting plan or effective national market system plan.

This change is designed to provide a clearer, more descriptive, and less circular definition of "subject security" by indicating that the trading volume referred to in the definition is the

trading volume in a security that is reported pursuant to an effective transaction reporting plan or an effective national market system plan. Although replacing the phrase "reported in the consolidated system" with the phrase "reported pursuant to an effective transaction reporting plan or an effective national market system plan" would produce a clearer definition of "subject security," it would not alter the scope or the substance of the definition.[342]

v. "National securities exchange"

Section 3(a)(1) of the Exchange Act defines the term "exchange" to mean "any organization, association, or group of persons…which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood…."[343] Exchange Act Rule 3b-16,[344] adopted in 1998, interprets the statutory definition of "exchange" broadly to include any organization, association, or group of persons that: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade. Exchange Act Rule 3b-16

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342 This proposed amendment would also impact certain non-NMS rules that define the term consolidated system. See, e.g., Exchange Act Rule 10b-18(a)(7) ("consolidated system means the consolidated transaction reporting system contemplated by Rule 11Aa3-1"). As discussed below, the Commission is also proposing to change certain non-NMS rules that are impacted by the definitional changes proposed in this Release.

343 15 USC 78c(a)(1).

344 17 CFR 240.3b-16.

was designed to provide "a more comprehensive and meaningful interpretation of what an exchange is in light of today's markets."[345]

The Quote Rule's definition of an "exchange market maker" defines the term "national securities exchange" as an "exchange."[346] To avoid confusion between a "national securities exchange" and the broader interpretation of "exchange" set forth in Exchange Act Rule 3b-16, the Commission proposes to use the term "national securities exchange" rather than "exchange" throughout proposed Regulation NMS. The national securities exchange definition is intended to capture only those entities that operate as national securities exchanges and that are registered as such with the Commission. It is not intended to capture those entities that meet the "exchange" definition under Regulation ATS but that operate as something other than a national securities exchange. The use of this term is consistent with the use of the term "exchange" in the current NMS rules.

vi. "OTC market maker"

The Quote Rule and Exchange Act Rule 11Ac1-5 define the term "OTC market maker" differently.[347] Unlike the Quote Rule, Exchange Act Rule 11Ac1-5 defines the term "OTC market maker" to include an explicit reference to a securities dealer that holds itself out as being willing to buy from and sell to customers or others in the United States. In proposed Regulation NMS, the Commission proposes to retain the reference to transactions with "customers or others

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345 See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1999) (adopting Regulation ATS).

346 Specifically, the Quote Rule states that the term "exchange market maker" shall mean "any member of a national securities exchange ('exchange') who is registered as a specialist or market maker pursuant to the rules of such exchange." See Exchange Act Rule 11Ac1-1(a)(9). The statutory requirements applicable to a national securities exchange are set forth in Section 6 of the Exchange Act, 15 USC 78f.

347 Compare Exchange Act Rules 11Ac1-1(a)(13) and 11Ac1-5(a)(18).

in the United States" to indicate clearly that a foreign dealer could be an "OTC market maker" if it acts as a securities dealer with respect to customers or others in the United States.

Accordingly, the Commission proposes to define "OTC market maker" for proposed Regulation NMS as "any dealer that holds itself out as being willing to buy from and sell to its customers, or others, in the United States, an NMS stock for its own account on a regular or continuous basis otherwise than on a national securities exchange."[348]

vii. "Vendor"

The term "vendor" or "quotation vendor" is defined differently in three NMS rules: the Quote Rule and Exchange Act Rules 11Aa3-1 and 11Ac1-2.[349] Although the definitions are similar, the definition of "vendor" in Exchange Act Rule 11Ac1-2 is the most comprehensive because it encompasses any SIP that disseminates transaction reports, last sale data, or quotation information, whereas the other definitions are less complete in identifying the types of information that vendors typically make available. To provide a uniform and comprehensive

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348 The proposed definition of "OTC market maker" uses the term "NMS stock" because there is no OTC market in standardized options.

349 The Quote Rule defines the term "quotation vendor" to mean "any securities information processor engaged in the business of disseminating to brokers, dealers or investors on a real-time basis, bids and offers made available pursuant to this section, whether distributed through an electronic communications network or displayed on a terminal or other display device." See Exchange Act Rule 11Ac1-1(a)(19). Exchange Act Rule 11Aa3-1(a)(11) defines the term "vendor" to mean "any securities information processor engaged in the business of disseminating transaction reports or last sale data with respect to transactions in reported securities to brokers, dealers or investors on a real-time or other current and continuing basis, whether through an electronic communications network, moving ticker or interrogation device." Exchange Act Rule 11Ac1-2(a)(2) defines the term "vendor" to mean "any securities information processor engaged in the business of disseminating transaction reports, last sale data or quotation information with respect to subject securities to brokers, dealers or investors on a real-time or other current and continuing basis, whether through an electronic communications network, moving ticker or interrogation device."

definition of the term "vendor," the Commission proposes to use in Regulation NMS the definition of "vendor" as it is currently defined in Exchange Act Rule 11Ac1-2(a)(2).

viii. "Best bid," "best offer," and "national best bid and national best offer"

The Quote Rule and Rule 11Ac1-2 define the terms "best bid" and "best offer" differently.[350] In addition, the term "consolidated best bid and offer" is defined in Exchange Act Rule 11Ac1-5(a)(7) to mean "the highest firm bid and the lowest firm offer for a security that is calculated and disseminated on a current and continuous basis pursuant to an effective national market system plan." The Commission proposes to retain the definitions of "best bid" and "best offer" as used in the Quote Rule. A new term called "national best bid and national best offer" would: (1) replace the term "best bid and best offer" as that term is currently used in Exchange Act Rule 11Ac1-2 and (2) replace the term "consolidated best bid and offer" as that term is currently used in Exchange Act Rule 11Ac1-5. This new term would refer to the best quotes that

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350 The Quote Rule states that "[t]he terms best bid and best offer shall mean the highest priced bid and the lowest priced offer." See Exchange Act Rule 11Ac1-1(a)(3). Exchange Act Rule 11Ac1-2(a)(15) defines the terms "best bid" and "best offer" as follows:

(i) With respect to quotations for a reported security, the highest bid or lowest offer for that security made available by any reporting market center pursuant to § 240.11Ac1-1 (Rule 11Ac1-1 under the Act) (excluding any bid or offer made available by an exchange during any period such exchange is relieved of its obligations under paragraphs (b) (1) and (2) of § 240.11Ac1-1 by virtue of paragraph (b)(3)(i) thereof)); Provided, however, That in the event two or more reporting market centers make available identical bids or offers for a reported security, the best bid or best offer (as the case may be) shall be computed by ranking all such identical bids or offers (as the case may be) first by size (giving the highest ranking to the bid or offer associated with the largest size), then by time (giving the highest ranking to the bid or offer received first in time); and

(ii) With respect to quotations for a subject security other than a reported security, the highest bid or lowest offer (as the case may be) for such security disseminated by an over-the-counter market maker in Level 2 or 3 of NASDAQ.

are calculated and disseminated by a plan processor pursuant to an effective NMS plan.[351] The proposed definition of "national best bid and national best offer" also would address those instances where multiple market centers transmit identical bids and offers to the plan processor pursuant to an NMS plan by establishing the way in which these bids and offers are to be prioritized.

ix. "Bid" or "offer," "customer," "Nasdaq security," and "responsible broker or dealer"

The Commission also proposes to update or clarify the following terms in the NMS rules: "bid" or "offer;" "customer;" "Nasdaq security;" and "responsible broker or dealer."

The Quote Rule currently defines the terms "bid and offer" to mean "the bid price and the offer price communicated by an exchange member or OTC market maker to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of a covered security, as either principal or agent, but shall not include indications of interest."[352] The Commission proposes to update this definition by replacing the term "OTC market maker" with the phrase "member of a national securities association" and to call the term "bid or offer" rather than "bid and offer" to reflect the fact that the terms are not always used in the

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351 The definition of "reporting market center" currently in Rule 11Ac1-2(a)(14) and incorporated into that Rule's definitions of "best bid" and "best offer" would no longer be necessary and therefore would be deleted.

352 See Exchange Act Rule 11Ac1-1(a)(4). Exchange Act Rule 11Ac1-2(a)(6) uses the Quote Rule's definition of "bid" and "offer" for reported securities, but it defines "bid" and "offer" for Nasdaq SmallCap securities as "the most recent bid or offer price of an over-the-counter market maker disseminated through Level 2 or 3 of NASDAQ." Because Nasdaq SmallCap securities now are reported securities, it is unnecessary to maintain the distinction between reported securities and Nasdaq SmallCap securities. Accordingly, to update and provide a single definition of the terms "bid" and "offer," the Commission proposes to eliminate the definitions of "bid" and "offer" in Exchange Act Rule 11Ac1-2 and retain modified versions of the terms as they are defined in the Quote Rule.

conjunctive. Modifying the definition to apply to any member of a national securities association would clarify that bids and offers include quotes communicated not only by OTC market makers but also by ATSs, ECNs, and order entry firms that are members of the NASD but that are not market makers.

Expanding the bid and offer terms could have the unintended consequence of also expanding the scope of the Quote Rule where those terms are used to apply to members of a national securities association that are not OTC market makers (e.g., ECNs, and ATSs). To avoid this unintended expansion of the scope of the Quote Rule, the Commission is proposing to amend the definition of "responsible broker or dealer." In particular, the Commission is proposing to amend the portion of that definition currently in Rule 11Ac1-1(a)(21)(ii) to limit its scope to bids and offers communicated by an OTC market maker.

The Commission is also proposing to amend the definition of the term "customer." The Quote Rule currently defines that term to mean "any person that is not a registered broker-dealer."[353] To indicate that the scope of the definition includes broker-dealers that are exempt from registration as well as registered broker-dealers, the Commission proposes to revise the definition by deleting the term "registered." Thus, proposed Rule 600 would define the term "customer" to mean "any person that is not a broker-dealer."

Exchange Act Rule 11Aa3-1 currently defines the term "NASDAQ security" to mean "any registered equity security for which quotation information is disseminated in the National Association of Securities Dealers Automated Quotation system ("NASDAQ")."[354] This acronym is now out-dated. Therefore, to modernize this definition and to ensure that any type of

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[353] See Exchange Act Rule 11Ac1-1(a)(26).

[354] See Exchange Act Rule 11Aa3-1(a)(6).

registered security that Nasdaq lists is covered by this definition, the Commission proposes to define the term "Nasdaq security" to mean "any registered security listed on the Nasdaq Stock Market, Inc."

d. Definitions in the Proposed New Rules

The Commission also is proposing to include within proposed new Rule 600 a number of new definitions that would be used in proposed new Rules 610 through 612 of proposed Regulation NMS. These new terms are discussed in detail in Sections III, IV, and V above. Specifically, for the reasons discussed above, the Commission proposes to adopt the following terms:

- The term Automated order execution facility shall mean an order execution facility that provides for an immediate automated response to all incoming subject orders for up to the full size of its best bid and offer disseminated pursuant to an effective national market system plan without any restriction on execution.
- The term Consolidated display shall mean (i) the prices, sizes, and market identifications of the national best bid and national best offer for a security, and (ii) consolidated last sale information for a security.
- The term Consolidated last sale information shall mean the price, volume, and market identification of the most recent transaction report for a security that is disseminated pursuant to an effective national market system plan.
- The term Non-automated order execution facility shall mean an order execution facility that is not an automated order execution facility.
- The term Order execution facility shall mean any exchange market maker; OTC market maker; any other broker or dealer that executes orders internally by trading as principal or

crossing orders as agent; alternative trading system; or national securities exchange or national securities association that operates a facility that executes orders.

- The term Quoting market center shall mean an order execution facility of any national securities exchange or national securities association that is required to make available to a vendor its best bid or best offer in a security pursuant to § 242.602).
- The term Quoting market participant shall mean any broker or dealer that provides its best bid or best offer in a security to a national securities exchange or national securities association pursuant to § 242.602) or Regulation ATS (§§ 242.300 through 242.303), and the best bid or best offer of which is not otherwise available through a quoting market center.
- The term Subject order shall mean any order to buy or sell an NMS stock received by an order execution facility from itself, any member, customer, subscriber, or any other order execution facility that is executed during regular trading hours.
- The term Trade-through shall mean the purchase or sale of an NMS stock during regular trading hours, either as principal or agent, at a price that is lower than the best bid or higher than the best offer of any order execution facility that is disseminated pursuant to an effective national market system plan at the time the transaction was executed.

The Commission requests comment on the proposed definitions that would be used in proposed new Rules 610 through 612.

3. Proposed Changes to Other Rules

In addition to the changes described above, the Commission is proposing to amend a number of rules that cross-reference current NMS rules or that use terms that proposed

Regulation NMS would amend or eliminate.[355] These amendments are intended to be non-substantive. Specifically, the Commission proposes to make conforming changes to the following rules: § 200.30-3;[356] Rule 144[357] under the Securities Act of 1933;[358] Exchange Act Rule 31-1;[359] § 249.1001;[360] Exchange Act Rule 3a51-1[361]; Exchange Act Rule 3b-16;[362] Exchange Act Rule 10b-10;[363] Exchange Act Rule 10b-18;[364] Exchange Act Rule 15b9-1;[365]

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355 Certain other rules that would be impacted by proposed Regulation NMS that are also the subject of other proposed Commission rulemakings that are currently pending, such as Exchange Act Rule 10a-1 (17 CFR 240.10a-1), are not included in this proposal. See Securities Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972 (November 6, 2003) (proposing new Regulation SHO regarding short sales, which would, among other things, repeal Rule 10a-1).

356 17 CFR 300.30-3. In addition to the conforming changes, as discussed below, the Commission is proposing to amend this rule to grant the Director of the Division of Market Regulation the authority to grant exemptions to proposed new Rules 610 through 612.

357 17 CFR 230.144.

358 15 USC 77a et seq.

359 17 CFR 240.31-1.

360 17 CFR 249.1001.

361 17 CFR 3a51-1.

362 17 CFR 240.3b-16.

363 17 CFR 240.10b-10. Proposed amendments to Exchange Act Rules 3a51-1 and Rule 10b-10 are currently under consideration and have been published for comment. See Securities Exchange Act Release Nos. 49148 (January 29, 2004) and 49037 (January 8, 2004). If the amendments to one or both of these rules are adopted before the amendments proposed in this release, then the new definitions would also have to be revised.

364 17 CFR 240.10b-18.

365 17 CFR 240.15b9-1.

Exchange Act Rule 12a-7;[366] Exchange Act Rule 12f-1;[367] Exchange Act Rule 12f-2;[368] Exchange Act Rule 15c2-11;[369] Exchange Act Rule 19c-3;[370] Exchange Act Rule 19c-4;[371] Rule 100 of Regulation M under the Exchange Act;[372] Rule 300 of Regulation ATS under the Exchange Act;[373] and Rule 301 of Regulation ATS under the Exchange Act.[374]

4. Exemptive Authority

Proposed Rules 610, 611, and 612 each provide that the Commission may exempt persons from the provisions of those rules, either conditionally or unconditionally, if it determines such exemption is consistent with the public interest and the protection of investors. In addition, the Commission is proposing to amend 17 CFR 200.30-3 to grant the Director of the Division of Market Regulation delegated authority to grant exemptions from the provisions of proposed Regulation NMS.

C. General Request for Comment

The Commission seeks comment on proposed Rule 600 and the designation of the NMS rules as proposed Regulation NMS, as described above. The Commission asks commenters to address whether the proposal would further the NMS goals set out in Section 11A of the

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366 17 CFR 240.12a-7.

367 17 CFR 240.12f-1.

368 17 CFR 240.12f-2.

369 17 CFR 240.15c2-11.

370 17 CFR 240.19c-3.

371 17 CFR 240.19c-4.

372 17 CFR 242.100.

373 17 CFR 242.300.

374 17 CFR 242.301.

Exchange Act, and whether the definitions contained in proposed Rule 600 are appropriate and accurate. The Commission also seeks comment on whether the technical changes proposed to the NMS rules successfully preserve the scope of the current rules. In addition, the Commission seeks specific comment on whether additional, non-substantive modifications could be made to the NMS rules to enhance clarity or remove outdated references. The Commission also invites commenters to provide views and data concerning the costs and benefits associated with the proposal.

D. Paperwork Reduction Act

Neither proposed Rule 600 nor any of the conforming amendments to the NMS rules proposed in Section VII impose recordkeeping or information collection requirements, or other collections of information that require the approval of the Office of Management and Budget under 44 U.S.C. 3501, et seq. Accordingly, the Paperwork Reduction Act does not apply.

E. Consideration of Costs and Benefits

The Commission proposes to designate the NMS rules as proposed Regulation NMS and to adopt and include in proposed new Regulation NMS a separate definitional rule, proposed Rule 600, that would contain all of the defined terms used in proposed Regulation NMS and make certain conforming amendments to the NMS rules. Currently, each NMS rule includes its own set of definitions and some identical terms, such as “covered security,” “reported security,” and “subject security” are defined inconsistently. Although proposed Rule 600 would retain, unchanged, most of the definitions used in the NMS rules, it would delete or revise obsolete definitions and eliminate the use of inconsistent definitions for identical terms. Proposed Rule 600 would not alter the requirements or operation of the existing NMS rules. By creating a

single set of defined terms for Regulation NMS, proposed Rule 600 should make the NMS rules clearer and easier to understand.

The Commission has identified below certain costs and benefits relating to the proposal. The Commission requests comments on all aspects of this cost-benefit analysis, including identification of any additional costs or benefits of the proposal. The Commission encourages commenters to identify and supply any relevant data, analysis, and estimates concerning the costs or benefits of the proposal.

1. Benefits

The Commission preliminarily believes that proposed Rule 600 and the related proposed amendments would benefit all entities that are subject to the requirements of proposed Regulation NMS including broker-dealers, national securities exchanges, the NASD, ECNs, SIPs, and vendors. By eliminating or revising obsolete and inconsistent definitions and adopting a single set of definitions that would be used throughout proposed Regulation NMS, proposed Rule 600 should make proposed Regulation NMS easier to understand, thereby facilitating compliance with its requirements and potentially easing the compliance burden on entities subject to proposed Regulation NMS. Increased compliance with proposed Regulation NMS would, in turn, benefit investors and the public interest.

2. Costs

Proposed Rule 600 would update and clarify the definitions used in the NMS rules. Neither proposed Rule 600 nor the related proposed amendments would alter the existing requirements of the NMS rules. Accordingly, the Commission believes that the proposed changes would likely impose few additional costs on entities subject to proposed Regulation

NMS. Although some additional personnel costs may be incurred in reviewing the proposed changes, the Commission believes that these costs would be minimal.

F. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act[375] requires the Commission, whenever it engages in rulemaking or in the review of a rule of an SRO, and it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act[376] requires the Commission, in adopting rules under the Exchange Act, to consider the impact that any such rule would have on competition. Section 23(a)(2) of the Exchange Act prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Proposed Rule 600 and the related proposed amendments should help to promote efficiency and capital formation by making the NMS rules easier to understand, thereby helping to reduce compliance costs for entities subject to the rules. Enhanced clarity in the definitions used in proposed Regulation NMS also should benefit investors and the public interest by facilitating compliance with the requirements of proposed Regulation NMS. Because proposed Rule 600 would merely clarify the definitions used in proposed Regulation NMS without imposing new requirements, and because the related proposed amendments would create no new requirements, this proposal should not impose a burden on competition or alter the competitive standing of entities subject to proposed Regulation NMS.

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[375] 15 U.S.C. 78c(f).

[376] 15 U.S.C. 78w(a)(2).

The Commission requests comment on whether the proposed changes are expected to affect efficiency, competition, and capital formation.

G. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[377] the Commission must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effect on competition, investment, or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. The Commission requests comment on the potential impact of the proposal on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

H. Regulatory Flexibility Act Certification

The Commission hereby certifies, pursuant to 5 USC 605(b), that proposed Rule 600 and the related proposed amendments, if adopted, would not have a significant economic impact on a substantial number of small entities. Proposed Rule 600 would revise and clarify the definitions used in proposed Regulation NMS, thereby facilitating compliance with proposed Regulation NMS and potentially easing the compliance burden on entities seeking to comply with the regulation. Neither proposed Rule 600 nor the related proposed amendments of the NMS rules

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[377] Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 USC, 15 USC and as a note to 5 USC 601).

would alter the existing requirements of the NMS rules. Accordingly, the Commission does not believe that proposed Rule 600 and the re-designation of the NMS rules as proposed Regulation NMS would have a significant impact on a substantial number of small entities.

The Commission encourages written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

VIII. Statutory Authority

Pursuant to the Exchange Act and particularly, Sections 2, 3(b), 5, 6, 11A, 15, 15A, 17(a) and (b), 19, 23(a), and 36 thereof, 15 U.S.C. 78b, 78c(b), 78e, 78f, 78k-1, 78o, 78o-3, 78q(a) and (b), 78s; 78w(a), and 78mm, and Rules 11Aa3-2(b)(2) and 11Aa3-2(c)(1) thereunder, 17 CFR 240.11Aa3-2(b)(2) and 17 CFR 240.11Aa3-2(c)(1), the Commission proposes to: (1) redesignate the NMS rules under Section 11A of the Exchange Act as Regulation NMS rules; (2) adopt Rules 600, 610, 611, and 612 of Regulation NMS; (3) amend current Rules 11Aa3-1 and 11Ac1-2 under the Exchange Act and redesignate them as Rules 601 and 603 of Regulation NMS; (4) amend the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan; and (5) amend various other rules to reflect the adoption of Regulation NMS, as set forth below.

IX. Text of the Proposed Amendments to the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan

The Commission hereby proposes to amend the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan to incorporate the new net income allocation formula into each Plan, which would supercede the existing allocation formulas in those Plans, and to incorporate the new Plan governance language into each Plan.

Set forth below is the text of (1) the proposed new allocation formula to be incorporated into each of the Plans, and (2) the proposed new Plan governance language to be incorporated into each of the Plans.

Proposed Formula Amendment

(#) Allocation of Net Income.

(a) Annual Payment. Notwithstanding any other provision of this Plan, each Participant eligible to receive distributable net income under the Plan shall receive an annual payment for each calendar year that is equal to the sum of the Participant's Trading Shares,

Quoting Shares, and NBBO Improvement Shares, as defined below, in each Eligible Security for the calendar year.

(b) Security Income Allocation. The Security Income Allocation for an Eligible Security shall be determined by multiplying (i) the distributable net income of the Plan for the calendar year by (ii) the Volume Percentage for such Eligible Security. The Volume Percentage for an Eligible Security shall be determined by dividing (i) the square root of the dollar volume of transaction reports disseminated by the Processor in such Eligible Security during the calendar year by (ii) the sum of the square roots of the dollar volume of transaction reports disseminated by the Processor in each Eligible Security during the calendar year.

(c) Trading Share. The Trading Share of a Participant in an Eligible Security shall be determined by multiplying (i) an amount equal to the lesser of (A) fifty percent of the Security Income Allocation for the Eligible Security or (B) an amount equal to $2.00 multiplied by the total number of qualified transaction reports disseminated by the Processor in the Eligible Security during the calendar year, by (ii) the Participant's Trade Rating in the Eligible Security. A Participant's Trade Rating in an Eligible Security shall be determined by taking the average of (i) the Participant's percentage of the total dollar volume of transaction reports disseminated by the Processor in the Eligible Security during the calendar year, and (ii) the Participant's percentage of the total number of qualified transaction reports disseminated by the Processor in the Eligible Security during the calendar year. A qualified transaction report shall have a dollar volume of $5,000 or greater.

(d) Quoting Share. The Quoting Share of a Participant in an Eligible Security shall be determined by multiplying (i) an amount equal to thirty-five percent of the Security Income Allocation for the Eligible Security, plus the difference, if greater than zero, between fifty

percent of the Security Income Allocation for the Eligible Security and an amount equal to $2.00 multiplied by the total number of qualified transaction reports disseminated by the Processor in the Eligible Security during the calendar year, by (ii) the Participant's Quote Rating in the Eligible Security. A Participant's Quote Rating in an Eligible Security shall be determined by dividing (i) the sum of the Quote Credits earned by the Participant in such Eligible Security during the calendar year by (ii) the sum of the Quote Credits earned by all Participants in such Eligible Security during the calendar year. A Participant shall earn one Quote Credit for each second of time multiplied by dollar value of size that a firm bid (offer) transmitted by the Participant to the Processor during regular trading hours is equal to the price of the national best bid (offer) in the Eligible Security; provided, however, with respect to quotes transmitted by a Participant that are not fully accessible through automatic execution, that such quotes will cease earning credits when they are left alone at the national best bid (offer) as a result of quote changes transmitted by other Participants. A Participant may recommence earning credits for a quote that is left alone at the national best bid (offer) by retransmitting the quote to confirm a current willingness to trade at the price of such quote. The dollar value of size of a quote shall be determined by multiplying the price of a quote by its size.

(e) NBBO Improvement Share. The NBBO Improvement Share of a Participant in an Eligible Security shall be determined by multiplying (i) an amount equal to fifteen percent of the Security Income Allocation for the Eligible Security by (ii) the Participant's NBBO Improvement Rating in the Eligible Security. A Participant's NBBO Improvement Rating in an Eligible Security shall be determined by dividing (i) the sum of the NBBO Improvement Credits earned by the Participant in such Eligible Security during the calendar year by (ii) the sum of the NBBO Improvement Credits earned by all Participants in such Eligible Security during the

calendar year. A Participant shall earn one NBBO Improvement Credit for each five seconds of time multiplied by the dollar value of size that a firm bid (offer) transmitted by the Participant to the Processor during regular trading hours increases (lowers) the price of the existing national best bid (offer) in the Eligible Security ("Qualified Quote") and continues to remain equal to the price of the national best bid (offer) in such Eligible Security. In addition, a Participant shall earn NBBO Improvement Credits for a Qualified Quote equal to the total amount of dollar volume of the Participant's transaction reports in the Eligible Security (i) that are transmitted after the Qualified Quote and up to five seconds after the price of the Qualified Quote no longer continues to equal the price of the national best bid (offer) in such Eligible Security, and (ii) that have prices equal to the price of the Qualified Quote; provided, however, that the total NBBO Improvement Credits for a Qualified Quote earned from transaction reports shall not exceed an amount equal to the initial dollar value of size of such Qualified Quote plus the total number of NBBO Improvement Credits earned for the time and size of such Qualified Quote.

Proposed Governance Amendment

(#) Advisory Committee.

(a) Formation. Notwithstanding any other provision of this Plan, an Advisory Committee to the Plan shall be formed and shall function in accordance with the provisions set forth in this section.

(b) Composition. Members of the Advisory Committee shall be selected for two-year terms as follows:

(1) Operating Committee Selections. By affirmative vote of a majority of the Participants entitled to vote, the Operating Committee shall select at least one representative from each of the following categories to be members of the Advisory Committee: (i) a broker-

dealer with a substantial retail investor customer base, (ii) a broker-dealer with a substantial institutional investor customer base, (iii) an alternative trading system, (iv) a data vendor, and (v) an investor.

(2) Participant Selections. Each Participant shall have the right to select one member of the Advisory Committee. A Participant shall not select any person employed by or affiliated with any Participant.

(c) Function. Members of the Advisory Committee shall have the right to submit their views to the Operating Committee on Plan matters, prior to a decision by the Operating Committee on such matters. Such matters shall include, but not be limited to, any new or modified product, fee, contract, or pilot program that is offered or used pursuant to the Plan.

(d) Meetings and Information. Members of the Advisory Committee shall have the right to attend all meetings of the Operating Committee and to receive any information concerning plan matters that is distributed to the Operating Committee; provided, however, that the Operating Committee may meet in executive session if, by affirmative vote of a majority of the Participants entitled to vote, the Operating Committee determines that an item of Plan business requires confidential treatment.

X. Text of Proposed Rules

List of Subjects

17 CFR Part 200

Administrative practice and procedure, Authority delegations (Government agencies), Organization and functions (Government agencies).

17 CFR Part 230

Reporting and recordkeeping requirements, Securities.

17 CFR Parts 240, 242, and 249

Brokers, Reporting and recordkeeping requirements, Securities.

Text of Proposed Rules

For the reasons set out in the preamble, Title 17, Chapter II of the Code of the Federal Regulations is proposed to be amended as follows:

PART 200—ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

1. The authority citation for part 200 continues to read in part as follows:

Authority: 15 U.S.C. 77s, 78d–1, 78d–2, 78w, 78ll(d), 78mm, 79t, 77sss, 80a–37, 80b–11, unless otherwise noted.

* * * * *

2. Section 200.30-3 is amended by:

(a) Removing paragraphs (a)(62) and (a)(71);

(b) Redesignating paragraphs (a)(63) through (a)(78) as paragraphs (a)(62) through (a)(76);

(c) Revising paragraphs (a)(27), (a)(28), (a)(36), (a)(37), (a)(42), (a)(49), (a)(61), and newly redesignated paragraphs (a)(68), and (a)(69); and

(d) Adding new paragraphs (a)(77), (a)(78), and (a)(79).

The revisions and additions read as follows:

§ 200.30-3 Delegation of authority to Director of Division of Market Regulation.

* * * * *

(a) * * *

(27) To approve amendments to the joint industry plan governing consolidated transaction reporting declared effective by the Commission pursuant to Rule 601 (17 CFR

242.601) or its predecessors, Rule 11Aa3-1 and Rule 17a-15, and to grant exemptions from Rule 601 pursuant to Rule 601(f) (17 CFR 242.601(f)) to exchanges trading listed securities that are designated as national market system securities until such times as a Joint Reporting Plan for such securities is filed and approved by the Commission.

(28) To grant exemptions from Rule 602 (17 CFR 242.602), pursuant to Rule 602(d) (17 CFR 242.602(d)).

* * * * *

(36) To grant exemptions from Rule 603 (17 CFR 242.603), pursuant to Rule 603(c) (17 CFR 242.603(c)).

(37) Pursuant to Rule 600 (17 CFR 242.600), to publish notice of the filing of a designation plan with respect to national market system securities, or any proposed amendment thereto, and to approve such plan or amendment.

* * * * *

(42) Under 17 CFR 242.608(e), to grant or deny exemptions from 17 CFR 242.608.

* * * * *

(49) Pursuant to section 11A(b) of the Act (15 U.S.C. 78k-1(b)) and Rule 609 thereunder (17 CFR 242.609), to publish notice of and, by order, grant under section 11A(b) of the Act and Rule 609 thereunder: Applications for registration as a securities information processor; and exemptions from that section and any rules or regulations promulgated thereunder, either conditionally or unconditionally.

* * * * *

(61) To grant exemptions from Rule 604 (17 CFR 242.604), pursuant to Rule 604(c) (17 CFR 242.604(c)).

* * * * *

(68) Pursuant to Rule 605(b) (17 CFR 242.605(b)), to grant or deny exemptions, conditionally or unconditionally, from any provision or provisions of Rule 605 (17 CFR 242.605).

(69) Pursuant to Rule 606(c) (17 CFR 242.606(c)), to grant or deny exemptions, conditionally or unconditionally, from any provision or provisions of Rule 606 (17 CFR 242.606).

* * * * *

(77) To grant or deny exemptions from Rule 610 (17 CFR 242.610), pursuant to Rule 610(d) (17 CFR 242.610(d)).

(78) To grant or deny exemptions from Rule 611 (17 CFR 242.611), pursuant to Rule 611(d) (17 CFR 242.611(d)).

(79) To grant or deny exemptions from Rule 612 (17 CFR 242.612), pursuant to Rule 612(b) (17 CFR 242.612(b)).

* * * * *

PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

3. The general authority citation for part 230 is revised to read as follows:

Authority: 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78t, 78w, 78ll(d), 78mm, 79t, 77sss, 80a–8, 80a–24, 80a–28, 80a–29, 80a–30, and 80a–37, unless otherwise noted.

* * * * *

4. Section 230.144 is amended by:

(a) Removing the authority citation following §230.144; and

(b) Revising paragraph (e)(1)(iii).

The revision reads as follows:

§ 230.144 Persons deemed not to be engaged in a distribution and therefore not underwriters.

* * * * *

(e) * * *

(1) * * *

(iii) The average weekly volume of trading in such securities reported pursuant to an effective transaction reporting plan or an effective national market system plan as those terms are defined in § 242.600 of this chapter during the four-week period specified in paragraph (e)(1)(ii) of this section.

* * * * *

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

5. The general authority citation for part 240 is revised to read follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78ll, 78mm, 79q, 79t, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

6. Section 240.3a51-1 is amended by revising the introductory text of the section and the introductory text of paragraph (a) to read as follows:

§ 240.3a51-1 Definition of "penny stock".

For purposes of section 3(a)(51) of the Act (15 U.S.C. 78c(a)(51)), the term penny stock shall mean any equity security other than a security:

(a) That is an NMS stock, as defined in § 242.600 of this chapter, provided that:

* * * * *

7. Section 240.3b-16 is amended by revising paragraph (d) to read as follows:

§ 240.3b-16 Definitions of terms used in Section 3(a)(1) of the Act.

* * * * *

(d) For the purposes of this section, the terms bid and offer shall have the same meaning as under § 242.600 of this chapter.

* * * * *

8. Section 240.10b-10 is amended by:

a. Revising paragraphs (a)(2)(i)(C) and (a)(2)(ii)(B);

b. Removing paragraph (d)(8); and

c. Redesignating paragraphs (d)(9) and (d)(10) as paragraphs (d)(8) and (d)(9).

The revisions read as follows:

§ 240.10b-10 Confirmation of transactions.

* * * * *

(a) * * *

(2) * * *

(i) * * *

(C) For a transaction in any NMS stock as defined in § 242.600 of this chapter or any other equity security as to which transaction reports, last sale data or quotation information is disseminated through an automated quotation system sponsored by a registered national

securities association or a national securities exchange or a security authorized for quotation on an automated interdealer quotation system that has the characteristics set forth in section 17B of the Act (15 U.S.C. 78q-2), a statement whether payment for order flow is received by the broker or dealer for transactions in such securities and the fact that the source and nature of the compensation received in connection with the particular transaction will be furnished upon written request of the customer; provided, however, that brokers or dealers that do not receive payment for order flow in connection with any transaction have no disclosure obligations under this paragraph; and

* * * * *

(ii) * * *

(B) In the case of any other transaction in an NMS security as defined by § 242.600 of this chapter, or an equity security that is quoted on an automated quotation system sponsored by a registered national securities association or traded on a national securities exchange and that is subject to last sale reporting, the reported trade price, the price to the customer in the transaction, and the difference, if any, between the reported trade price and the price to the customer.

* * * * *

9. Section 240.10b-18 is amended by revising paragraph (a)(6) to read as follows:

§ 240.10b-18 – Purchases of certain equity securities by the issuer and others.

* * * * *

(a) * * *

(6) Consolidated system means a consolidated transaction or quotation reporting system that collects and publicly disseminates on a current and continuous basis transaction or

quotation information in common equity securities pursuant to an effective transaction reporting plan or an effective national market system plan (as those terms are defined in § 242.600 of this chapter).

* * * * *

10. The undesignated center heading preceding § 240.11Aa2-1 and §§ 240.11Aa2-1 through 240.11Ac1-6 are removed.

11. Section 240.12a-7 is amended by revising the introductory text of paragraph (a)(2) to read as follows:

§ 240.12a-7 Exemption of stock contained in standardized market baskets from section 12(a) of the Act.

(a) * * *

(2) The stock is an NMS stock as defined in § 242.600 of this chapter and is either:

* * * * *

12. Section 240.12f-1 is amended by:

a. Removing the authority citation following the section;

b. Removing “and” at the end of paragraph (a)(3); and

c. Revising paragraph (a)(4).

The revision reads as follows:

§ 240.12f-1 Applications for permission to reinstate unlisted trading privileges.

(a) * * *

(4) Whether transaction information concerning such security is reported pursuant to an effective transaction reporting plan contemplated by § 242.601 of this chapter;

* * * * *

13. Section 240.12f-2 is amended by revising paragraph (a) to read as follows:

§ 240.12f-2 Extending unlisted trading privileges to a security that is the subject of an initial public offering.

(a) General provision. A national securities exchange may extend unlisted trading privileges to a subject security when at least one transaction in the subject security has been effected on the national securities exchange upon which the security is listed and the transaction has been reported pursuant to an effective transaction reporting plan, as defined in § 242.600 of this chapter.

* * * * *

14. Section 240.15b9-1 is amended by:

a. Removing the authority citation following the section; and

b. Revising paragraph (c).

The revision reads as follows:

§ 240.15b9-1 Exemption for certain exchange members.

* * * * *

(c) For purposes of this section, the term Intermarket Trading System shall mean the intermarket communications linkage operated jointly by certain self-regulatory organizations pursuant to a plan filed with, and approved by, the Commission pursuant to § 242.608 of this chapter.

15. Section 240.15c2-11 is amended by revising paragraph (f)(5) to read as follows:

§ 240.15c2-11 Initiation or resumption of quotations without specified information.

* * * * *

(f) ***

(5) The publication or submission of a quotation respecting a security that is authorized for quotation in the Nasdaq system (as defined in § 242.600 of this chapter), and such authorization is not suspended, terminated, or prohibited.

* * * * *

16. Section 240.19c-3 is amended by revising paragraph (b)(6) to read as follows:

§ 240.19c-3 Governing off-board trading by members of national securities exchanges.

* * * * *

(b) * * *

(6) The term effective transaction reporting plan shall mean any plan approved by the Commission pursuant to § 242.601 of this chapter for collecting, processing, and making available transaction reports with respect to transactions in an equity security or class of equity securities.

17. Section 240.19c-4 is amended by revising paragraph (e)(6) to read as follows:

§ 240.19c-4 Governing certain listing or authorization determinations by national securities exchanges and associations.

* * * * *

(e) * * *

(6) The term exchange shall mean a national securities exchange, registered as such with the Securities and Exchange Commission pursuant to section 6 of the Act (15 U.S.C. 78f), which makes transaction reports available pursuant to § 242.601 of this chapter; and

* * * * *

18. Section 240.31-1 is amended by revising paragraph (e) to read as follows:

§ 240.31-1 Securities transactions exempt from transaction fees.

* * * * *

(e) Transactions which are executed outside the United States and are not reported, or required to be reported, to a transaction reporting association as defined in § 242.600 of this chapter and any approved plan filed under § 242.601 of this chapter;

* * * * *

PART 242—REGULATIONS M, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

19. The authority citation for part 242 is revised to read as follow:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

20. The part heading for part 242 is revised as set forth above.

21. Section 242.100 is amended by revising the definition for "electronic communications network" and "Nasdaq" found in paragraph (b) to read as follows:

§ 242.100 Preliminary note; definitions.

* * * * *

(b) * * *

Electronic communications network has the meaning provided in § 242.600.

* * * * *

Nasdaq means the electronic dealer quotation system owned and operated by The Nasdaq Stock Market, Inc.

* * * * *

22. Section 242.300 is amended by:

(a) Revising paragraphs (g) and (h);

(b) Removing paragraphs (i) and (j); and

(c) Redesignating paragraphs (k), (l), and (m) as paragraphs (i), (j), and (k).

The revisions read as follows:

§ 242.300 Definitions.

* * * * *

(g) NMS stock shall have the meaning provided in § 242.600; provided, however, that a debt or convertible security shall not be deemed an NMS stock for purposes of this Regulation ATS.

(h) Effective transaction reporting plan shall have the meaning provided in § 242.600.

* * * * *

23. Section 242.301 is amended by revising paragraphs (b)(3), (b)(5), and (b)(6) to read as follows:

§ 242.301 Requirements for alternative trading systems.

* * * * *

(b) * * *

(3) Order display and execution access.

(i) An alternative trading system shall comply with the requirements set forth in paragraph (b)(3)(ii) of this section, with respect to any NMS stock in which the alternative trading system:

(A) Displays subscriber orders to any person (other than alternative trading system employees); and

(B) During at least 4 of the preceding 6 calendar months, had an average daily trading volume of 5 percent or more of the aggregate average daily share volume for such NMS stock as reported by an effective transaction reporting plan.

(ii) Such alternative trading system shall provide to a national securities exchange or national securities association the prices and sizes of the orders at the highest buy price and the lowest sell price for such NMS stock, displayed to more than one person in the alternative trading system, for inclusion in the quotation data made available by the national securities exchange or national securities association to vendors pursuant to § 242.602.

(iii) With respect to any order displayed pursuant to paragraph (b)(3)(ii) of this section, an alternative trading system shall provide to any broker-dealer that has access to the national securities exchange or national securities association to which the alternative trading system provides the prices and sizes of displayed orders pursuant to paragraph (b)(3)(ii)(A) of this section, the ability to effect a transaction with such orders that is:

(A) Equivalent to the ability of such broker-dealer to effect a transaction with other orders displayed on the exchange or by the association; and

(B) At the price of the highest priced buy order or lowest priced sell order displayed for the lesser of the cumulative size of such priced orders entered therein at such price, or the size of the execution sought by such broker-dealer.

* * * * *

(5) <u>Fair access.</u>

(i) An alternative trading system shall comply with the requirements in paragraph (b)(5)(ii) of this section, if during at least 4 of the preceding 6 calendar months, such alternative trading system had:

(A) With respect to any NMS stock, 5 percent or more of the average daily volume in that security reported by an effective transaction reporting plan;

(B) With respect to an equity security that is not an NMS stock and for which transactions are reported to a self-regulatory organization, 5 percent or more of the average daily trading volume in that security as calculated by the self-regulatory organization to which such transactions are reported;

(C) With respect to municipal securities, 5 percent or more of the average daily volume traded in the United States;

(D) With respect to investment grade corporate debt, 5 percent or more of the average daily volume traded in the United States; or

(E) With respect to non-investment grade corporate debt, 5 percent or more of the average daily volume traded in the United States.

(ii) An alternative trading system shall:

(A) Establish written standards for granting access to trading on its system;

(B) Not unreasonably prohibit or limit any person in respect to access to services offered by such alternative trading system by applying the standards established under paragraph (b)(5)(ii)(A) of this section in an unfair or discriminatory manner;

(C) Make and keep records of:

(1) All grants of access including, for all subscribers, the reasons for granting such access; and

(2) All denials or limitations of access and reasons, for each applicant, for denying or limiting access; and

(D) Report the information required on Form ATS-R (§ 249.638 of this chapter) regarding grants, denials, and limitations of access.

(iii) Notwithstanding paragraph (b)(5)(i) of this section, an alternative trading system shall not be required to comply with the requirements in paragraph (b)(5)(ii) of this section, if such alternative trading system:

(A) Matches customer orders for a security with other customer orders;

(B) Such customers' orders are not displayed to any person, other than employees of the alternative trading system; and

(C) Such orders are executed at a price for such security disseminated by an effective transaction reporting plan, or derived from such prices.

(6) Capacity, integrity, and security of automated systems.

(i) The alternative trading system shall comply with the requirements in paragraph (b)(6)(ii) of this section, if during at least 4 of the preceding 6 calendar months, such alternative trading system had:

(A) With respect to any NMS stock, 20 percent or more of the average daily volume reported by an effective transaction reporting plan;

(B) With respect to equity securities that are not NMS stocks and for which transactions are reported to a self-regulatory organization, 20 percent or more of the average daily volume as calculated by the self-regulatory organization to which such transactions are reported;

(C) With respect to municipal securities, 20 percent or more of the average daily volume traded in the United States;

(D) With respect to investment grade corporate debt, 20 percent or more of the average daily volume traded in the United States; or

(E) With respect to non-investment grade corporate debt, 20 percent or more of the average daily volume traded in the United States.

(ii) With respect to those systems that support order entry, order routing, order execution, transaction reporting, and trade comparison, the alternative trading system shall:

(A) Establish reasonable current and future capacity estimates;

(B) Conduct periodic capacity stress tests of critical systems to determine such system's ability to process transactions in an accurate, timely, and efficient manner;

(C) Develop and implement reasonable procedures to review and keep current its system development and testing methodology;

(D) Review the vulnerability of its systems and data center computer operations to internal and external threats, physical hazards, and natural disasters;

(E) Establish adequate contingency and disaster recovery plans;

(F) On an annual basis, perform an independent review, in accordance with established audit procedures and standards, of such alternative trading system's controls for ensuring that paragraphs (b)(6)(ii)(A) through (E) of this section are met, and conduct a review by senior management of a report containing the recommendations and conclusions of the independent review; and

(G) Promptly notify the Commission staff of material systems outages and significant systems changes.

(iii) Notwithstanding paragraph (b)(6)(i) of this section, an alternative trading system shall not be required to comply with the requirements in paragraph (b)(6)(ii) of this section, if such alternative trading system:

(A) Matches customer orders for a security with other customer orders;

(B) Such customers' orders are not displayed to any person, other than employees of the alternative trading system; and

(C) Such orders are executed at a price for such security disseminated by an effective transaction reporting plan, or derived from such prices.

* * * * *

24. Part 242 is amended by adding Regulation NMS, §§242.600 through 242.612 to read as follows:

REGULATION NMS – REGULATION OF THE NATIONAL MARKET SYSTEM

Sec.

242.600 NMS security designation and definitions.

242.601 Dissemination of transaction reports and last sale data with respect to transactions in NMS stocks.

242.602 Dissemination of quotations in NMS securities.

242.603 Distribution, consolidation, and display of information with respect to quotations for and transactions in NMS stocks.

242.604 Display of customer limit orders.

242.605 Disclosure of order execution information.

242.606 Disclosure of order routing information.

242.607 Customer account statements.

242.608 Filing and amendment of national market system plans.

242.609 Registration of securities information processors: form of application and amendments.

242.610 Access to published bids and offers.

242.611 Trade-through rule.

242.612 Minimum pricing increment.

REGULATION NMS – REGULATION OF THE NATIONAL MARKET SYSTEM

§ 242.600 NMS security designation and definitions.

(a) The term national market system security as used in section 11A(a)(2) of the Act (15 U.S.C. 78k-1(a)(2)) shall mean any NMS security as defined in paragraph (b) of this section.

(b) For purposes of Regulation NMS (§§ 242.600 through 242.612), the following definitions shall apply:

(1) Aggregate quotation size means the sum of the quotation sizes of all responsible brokers or dealers who have communicated on any national securities exchange bids or offers for an NMS security at the same price.

(2) Alternative trading system has the meaning provided in § 242.300(a).

(3) Automated order execution facility means an order execution facility that provides for an immediate automated response to all incoming subject orders for up to the full size of its best bid and best offer disseminated pursuant to an effective national market system plan without any restriction on execution.

(4) Average effective spread means the share-weighted average of effective spreads for order executions calculated, for buy orders, as double the amount of difference between the execution price and the midpoint of the national best bid and national best offer at the time of

order receipt and, for sell orders, as double the amount of difference between the midpoint of the national best bid and national best offer at the time of order receipt and the execution price.

(5) Average realized spread means the share-weighted average of realized spreads for order executions calculated, for buy orders, as double the amount of difference between the execution price and the midpoint of the national best bid and national best offer five minutes after the time of order execution and, for sell orders, as double the amount of difference between the midpoint of the national best bid and national best offer five minutes after the time of order execution and the execution price; provided, however, that the midpoint of the final national best bid and national best offer disseminated for regular trading hours shall be used to calculate a realized spread if it is disseminated less than five minutes after the time of order execution.

(6) Best bid and best offer mean the highest priced bid and the lowest priced offer.

(7) Bid or offer means the bid price or the offer price communicated by a member of a national securities exchange or member of a national securities association to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of an NMS security, as either principal or agent, but shall not include indications of interest.

(8) Block size with respect to an order means it is:

(i) Of at least 10,000 shares; or

(ii) For a quantity of stock having a market value of at least $200,000.

(9) Categorized by order size means dividing orders into separate categories for sizes from 100 to 499 shares, from 500 to 1999 shares, from 2000 to 4999 shares, and 5000 or greater shares.

(10) Categorized by order type means dividing orders into separate categories for market orders, marketable limit orders, inside-the-quote limit orders, at-the-quote limit orders, and near-the-quote limit orders.

(11) Categorized by security means dividing orders into separate categories for each NMS stock that is included in a report.

(12) Consolidated display means:

(i) The prices, sizes, and market identifications of the national best bid and national best offer for a security; and

(ii) Consolidated last sale information for a security.

(13) Consolidated last sale information means the price, volume, and market identification of the most recent transaction report for a security that is disseminated pursuant to an effective national market system plan.

(14) Covered order means any market order or any limit order (including immediate-or-cancel orders) received by a market center during regular trading hours at a time when a national best bid and national best offer is being disseminated, and, if executed, is executed during regular trading hours, but shall exclude any order for which the customer requests special handling for execution, including, but not limited to, orders to be executed at a market opening price or a market closing price, orders submitted with stop prices, orders to be executed only at their full size, orders to be executed on a particular type of tick or bid, orders submitted on a "not held" basis, orders for other than regular settlement, and orders to be executed at prices unrelated to the market price of the security at the time of execution.

(15) Customer means any person that is not a broker or dealer.

(16) Customer limit order means an order to buy or sell an NMS stock at a specified price that is not for the account of either a broker or dealer; provided, however, that the term customer limit order shall include an order transmitted by a broker or dealer on behalf of a customer.

(17) Customer order means an order to buy or sell an NMS security that is not for the account of a broker or dealer, but shall not include any order for a quantity of a security having a market value of at least $50,000 for an NMS security that is an option contract and a market value of at least $200,000 for any other NMS security.

(18) Directed order means a customer order that the customer specifically instructed the broker or dealer to route to a particular venue for execution.

(19) Dynamic market monitoring device means any service provided by a vendor on an interrogation device or other display that:

(i) Permits real-time monitoring, on a dynamic basis, of transaction reports, last sale data, or quotation information with respect to a particular security; and

(ii) Displays the most recent transaction report, last sale data, or quotation information with respect to that security until such report, data, or information has been superseded or supplemented by the display of a new transaction report, last sale data, or quotation information reflecting the next reported transaction or quotation in that security.

(20) Effective national market system plan means any national market system plan approved by the Commission (either temporarily or on a permanent basis) pursuant to § 242.608.

(21) Effective transaction reporting plan means any transaction reporting plan approved by the Commission pursuant to § 242.601.

(22) Electronic communications network means any electronic system that widely disseminates to third parties orders entered therein by an exchange market maker or OTC market maker, and permits such orders to be executed against in whole or in part; except that the term electronic communications network shall not include:

(i) Any system that crosses multiple orders at one or more specified times at a single price set by the system (by algorithm or by any derivative pricing mechanism) and does not allow orders to be crossed or executed against directly by participants outside of such times; or

(ii) Any system operated by, or on behalf of, an OTC market maker or exchange market maker that executes customer orders primarily against the account of such market maker as principal, other than riskless principal.

(23) Exchange market maker means any member of a national securities exchange that is registered as a specialist or market maker pursuant to the rules of such exchange.

(24) Exchange-traded security means any NMS security or class of NMS securities listed and registered, or admitted to unlisted trading privileges, on a national securities exchange; provided, however, that securities not listed on any national securities exchange that are traded pursuant to unlisted trading privileges are excluded.

(25) Executed at the quote means, for buy orders, execution at a price equal to the national best offer at the time of order receipt and, for sell orders, execution at a price equal to the national best bid at the time of order receipt.

(26) Executed outside the quote means, for buy orders, execution at a price higher than the national best offer at the time of order receipt and, for sell orders, execution at a price lower than the national best bid at the time of order receipt.

(27) Executed with price improvement means, for buy orders, execution at a price lower than the national best offer at the time of order receipt and, for sell orders, execution at a price higher than the national best bid at the time of order receipt.

(28) Inside-the-quote limit order, at-the-quote limit order, and near-the-quote limit order mean non-marketable buy orders with limit prices that are, respectively, higher than, equal to, and lower by $0.10 or less than the national best bid at the time of order receipt, and non-marketable sell orders with limit prices that are, respectively, lower than, equal to, and higher by $0.10 or less than the national best offer at the time of order receipt.

(29) Interrogation device means any securities information retrieval system capable of displaying transaction reports, last sale data, or quotation information upon inquiry, on a current basis on a terminal or other device.

(30) Joint self-regulatory organization plan means a plan as to which two or more self-regulatory organizations, acting jointly, are sponsors.

(31) Last sale data means any price or volume data associated with a transaction.

(32) Listed equity security means any equity security listed and registered, or admitted to unlisted trading privileges, on a national securities exchange.

(33) Listed option means any option traded on a registered national securities exchange or automated facility of a national securities association.

(34) Make publicly available means posting on an Internet website that is free and readily accessible to the public, furnishing a written copy to customers on request without charge, and notifying customers at least annually in writing that a written copy will be furnished on request.

(35) Market center means any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association.

(36) Marketable limit order means any buy order with a limit price equal to or greater than the national best offer at the time of order receipt, or any sell order with a limit price equal to or less than the national best bid at the time of order receipt.

(37) Moving ticker means any continuous real-time moving display of transaction reports or last sale data (other than a dynamic market monitoring device) provided on an interrogation or other display device.

(38) Nasdaq security means any registered security listed on The Nasdaq Stock Market, Inc.

(39) National market system plan means any joint self-regulatory organization plan in connection with:

(i) The planning, development, operation or regulation of a national market system (or a subsystem thereof) or one or more facilities thereof; or

(ii) The development and implementation of procedures and/or facilities designed to achieve compliance by self-regulatory organizations and their members with any section of this Regulation NMS and part 240, subpart A of this chapter promulgated pursuant to section 11A of the Act (15 U.S.C. 78k-1).

(40) National securities association means any association of brokers and dealers registered pursuant to section 15A of the Act (15 U.S.C. 78o-3).

(41) National securities exchange means any exchange registered pursuant to section 6 of the Act (15 U.S.C. 78f).

(42) National best bid and national best offer means, with respect to quotations for an NMS security, the best bid and best offer for such security that are calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan; provided, that in the event two or more market centers transmit to the plan processor pursuant to such plan identical bids or offers for an NMS security, the best bid or best offer (as the case may be) shall be determined by ranking all such identical bids or offers (as the case may be) first by size (giving the highest ranking to the bid or offer associated with the largest size), and then by time (giving the highest ranking to the bid or offer received first in time).

(43) NMS security means any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.

(44) NMS stock means any NMS security other than an option.

(45) Non-automated order execution facility means an order execution facility that is not an automated order execution facility.

(46) Non-directed order means any customer order other than a directed order.

(47) Odd-lot means an order for the purchase or sale of an NMS stock in an amount less than a round lot.

(48) Options class means all of the put option or call option series overlying a security, as defined in section 3(a)(10) of the Act (15 U.S.C. 78c(a)(10)).

(49) Options series means the contracts in an options class that have the same unit of trade, expiration date, and exercise price, and other terms or conditions.

(50) Order execution facility means any exchange market maker; OTC market maker; any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent; alternative trading system; or national securities exchange or national securities association that operates a facility that executes orders.

(51) OTC market maker means any dealer that holds itself out as being willing to buy from and sell to its customers, or others, in the United States, an NMS stock for its own account on a regular or continuous basis otherwise than on a national securities exchange in amounts of less than block size.

(52) Participants, when used in connection with a national market system plan, means any self-regulatory organization which has agreed to act in accordance with the terms of the plan but which is not a signatory of such plan.

(53) Payment for order flow has the meaning provided in § 240.10b-10 of this chapter.

(54) Plan processor means any self-regulatory organization or securities information processor acting as an exclusive processor in connection with the development, implementation and/or operation of any facility contemplated by an effective national market system plan.

(55) Profit-sharing relationship means any ownership or other type of affiliation under which the broker or dealer, directly or indirectly, may share in any profits that may be derived from the execution of non-directed orders.

(56) Published aggregate quotation size means the aggregate quotation size calculated by a national securities exchange and displayed by a vendor on a terminal or other display device at the time an order is presented for execution to a responsible broker or dealer.

(57) Published bid and published offer means the bid or offer of a responsible broker or dealer for an NMS security communicated by it to its national securities exchange or

association pursuant to § 242.602 and displayed by a vendor on a terminal or other display device at the time an order is presented for execution to such responsible broker or dealer.

(58) Published quotation size means the quotation size of a responsible broker or dealer communicated by it to its national securities exchange or association pursuant to § 242.602 and displayed by a vendor on a terminal or other display device at the time an order is presented for execution to such responsible broker or dealer.

(59) Quotation size, when used with respect to a responsible broker's or dealer's bid or offer for an NMS security, means:

(i) The number of shares (or units of trading) of that security which such responsible broker or dealer has specified, for purposes of dissemination to vendors, that it is willing to buy at the bid price or sell at the offer price comprising its bid or offer, as either principal or agent; or

(ii) In the event such responsible broker or dealer has not so specified, a normal unit of trading for that NMS security.

(60) Quotations and quotation information mean bids, offers and, where applicable, quotation sizes and aggregate quotation sizes.

(61) Quoting market center means an order execution facility of any national securities exchange or national securities association that is required to make available to a vendor its best bid or best offer in a security pursuant to § 242.602.

(62) Quoting market participant means any broker or dealer that provides its best bid or best offer in a security to a national securities exchange or national securities association pursuant to § 242.602 or Regulation ATS (§§ 242.300 through 242.303), and the best bid or best offer of which is not otherwise available through a quoting market center.

(63) Regular trading hours means the time between 9:30 a.m. and 4:00 p.m. Eastern Time, or such other time as is set forth in the procedures established pursuant to § 242.605(a)(2).

(64) Responsible broker or dealer means:

(i) When used with respect to bids or offers communicated on a national securities exchange, any member of such national securities exchange who communicates to another member on such national securities exchange, at the location (or locations) or through the facility or facilities designated by such national securities exchange for trading in an NMS security a bid or offer for such NMS security, as either principal or agent; provided, however, that, in the event two or more members of a national securities exchange have communicated on or through such national securities exchange bids or offers for an NMS security at the same price, each such member shall be considered a responsible broker or dealer for that bid or offer, subject to the rules of priority and precedence then in effect on that national securities exchange; and further provided, that for a bid or offer which is transmitted from one member of a national securities exchange to another member who undertakes to represent such bid or offer on such national securities exchange as agent, only the last member who undertakes to represent such bid or offer as agent shall be considered the responsible broker or dealer for that bid or offer; and

(ii) When used with respect to bids and offers communicated by an OTC market maker to a broker or dealer or a customer, the OTC market maker communicating the bid or offer (regardless of whether such bid or offer is for its own account or on behalf of another person).

(65) Revised bid or offer means a market maker's bid or offer which supersedes its published bid or published offer.

(66) Revised quotation size means a market maker's quotation size which supersedes its published quotation size.

(67) Self-regulatory organization means any national securities exchange or national securities association.

(68) Specified persons, when used in connection with any notification required to be provided pursuant to § 242.602(a)(3) and any election (or withdrawal thereof) permitted under § 242.602(a)(5), means:

(i) Each vendor;

(ii) Each plan processor; and

(iii) The processor for the Options Price Reporting Authority (in the case of a notification for a subject security which is a class of securities underlying options admitted to trading on any national securities exchange).

(69) Sponsor, when used in connection with a national market system plan, means any self-regulatory organization which is a signatory to such plan and has agreed to act in accordance with the terms of the plan.

(70) Subject order means any order to buy or sell an NMS stock received by an order execution facility from itself, any member, customer, subscriber or any other order execution facility that is executed during regular trading hours.

(71) Subject security means:

(i) With respect to a national securities exchange:

(A) Any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less

of the aggregate trading volume for such security as reported pursuant to an effective transaction reporting plan or effective national market system plan; and

(B) Any other NMS security for which such exchange has in effect an election, pursuant to § 242.602(a)(5)(i), to collect, process, and make available to a vendor bids, offers, quotation sizes, and aggregate quotation sizes communicated on such exchange; and

(ii) With respect to a member of a national securities association:

(A) Any exchange-traded security for which such member acts in the capacity of an OTC market maker unless the executed volume of such member, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported pursuant to an effective transaction reporting plan or effective national market system plan; and

(B) Any other NMS security for which such member acts in the capacity of an OTC market maker and has in effect an election, pursuant to § 242.602(a)(5)(ii), to communicate to its association bids, offers, and quotation sizes for the purpose of making such bids, offers, and quotation sizes available to a vendor.

(72) Time of order execution means the time (to the second) that an order was executed at any venue.

(73) Time of order receipt means the time (to the second) that an order was received by a market center for execution.

(74) Time of the transaction has the meaning provided in § 240.10b-10 of this chapter.

(75) Trade-through means the purchase or sale of an NMS stock during regular trading hours, either as principal or agent, at a price that is lower than the best bid or higher than the best

offer of any order execution facility that is disseminated pursuant to an effective national market system plan at the time the transaction was executed.

(76) Trading rotation means, with respect to an options class, the time period on a national securities exchange during which:

(i) Opening, re-opening, or closing transactions in options series in such options class are not yet completed; and

(ii) Continuous trading has not yet commenced or has not yet ended for the day in options series in such options class.

(77) Transaction report means a report containing the price and volume associated with a transaction involving the purchase or sale of one or more round lots of a security.

(78) Transaction reporting association means any person authorized to implement or administer any transaction reporting plan on behalf of persons acting jointly under § 242.601(a).

(79) Transaction reporting plan means any plan for collecting, processing, making available or disseminating transaction reports with respect to transactions in NMS stocks filed with the Commission pursuant to, and meeting the requirements of, § 242.601.

(80) Vendor means any securities information processor engaged in the business of disseminating transaction reports, last sale data, or quotation information with respect to NMS securities to brokers, dealers, or investors on a real-time or other current and continuing basis, whether through an electronic communications network, moving ticker, or interrogation device.

§ 242.601 Dissemination of transaction reports and last sale data with respect to transactions in NMS stocks.

(a)(1) Every national securities exchange shall file a transaction reporting plan regarding transactions in listed equity and Nasdaq securities executed through its facilities, and every

national securities association shall file a transaction reporting plan regarding transactions in listed equity and Nasdaq securities executed by its members otherwise than on a national securities exchange.

(2) Any transaction reporting plan, or any amendment thereto, filed pursuant to this section shall be filed with the Commission, and considered for approval, in accordance with the procedures set forth in § 242.608(a) and (b). Any such plan, or amendment thereto, shall specify, at a minimum:

(i) The listed equity and Nasdaq securities or classes of such securities for which transaction reports shall be required by the plan;

(ii) Reporting requirements with respect to transactions in listed equity securities and Nasdaq securities, for any broker or dealer subject to the plan;

(iii) The manner of collecting, processing, sequencing, making available and disseminating transaction reports and last sale data reported pursuant to such plan;

(iv) The manner in which such transaction reports reported pursuant to such plan are to be consolidated with transaction reports from national securities exchanges and national securities associations reported pursuant to any other effective transaction reporting plan;

(v) The applicable standards and methods which will be utilized to ensure promptness of reporting, and accuracy and completeness of transaction reports;

(vi) Any rules or procedures which may be adopted to ensure that transaction reports or last sale data will not be disseminated in a fraudulent or manipulative manner;

(vii) Specific terms of access to transaction reports made available or disseminated pursuant to the plan; and

(viii) That transaction reports or last sale data made available to any vendor for display on an interrogation device identify the marketplace where each transaction was executed.

(3) No transaction reporting plan filed pursuant to this section, or any amendment to an effective transaction reporting plan, shall become effective unless approved by the Commission or otherwise permitted in accordance with the procedures set forth in § 242.608.

(b) Prohibitions and reporting requirements.

(1) No broker or dealer may execute any transaction in, or induce or attempt to induce the purchase or sale of, any NMS stock:

(i) On or through the facilities of a national securities exchange unless there is an effective transaction reporting plan with respect to transactions in such security executed on or through such exchange facilities; or

(ii) Otherwise than on a national securities exchange unless there is an effective transaction reporting plan with respect to transactions in such security executed otherwise than on a national securities exchange by such broker or dealer.

(2) Every broker or dealer who is a member of a national securities exchange or national securities association shall promptly transmit to the exchange or association of which it is a member all information required by any effective transaction reporting plan filed by such exchange or association (either individually or jointly with other exchanges and/or associations).

(c) Retransmission of transaction reports or last sale data. Notwithstanding any provision of any effective transaction reporting plan, no national securities exchange or national securities association may, either individually or jointly, by rule, stated policy or practice, transaction reporting plan or otherwise, prohibit, condition or otherwise limit, directly or indirectly, the ability of any vendor to retransmit, for display in moving tickers, transaction

reports or last sale data made available pursuant to any effective transaction reporting plan; provided, however, that a national securities exchange or national securities association may, by means of an effective transaction reporting plan, condition such retransmission upon appropriate undertakings to ensure that any charges for the distribution of transaction reports or last sale data in moving tickers permitted by paragraph (d) of this section are collected.

(d) Charges. Nothing in this section shall preclude any national securities exchange or national securities association, separately or jointly, pursuant to the terms of an effective transaction reporting plan, from imposing reasonable, uniform charges (irrespective of geographic location) for distribution of transaction reports or last sale data.

(e) Appeals. The Commission may, in its discretion, entertain appeals in connection with the implementation or operation of any effective transaction reporting plan in accordance with the provisions of § 242.608(d).

(f) Exemptions. The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any national securities exchange, national securities association, broker, dealer, or specified security if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to, and perfection of the mechanisms of, a national market system.

§ 242.602 Dissemination of quotations in NMS securities.

(a) Dissemination requirements for national securities exchanges and national securities associations.

(1) Every national securities exchange and national securities association shall establish and maintain procedures and mechanisms for collecting bids, offers, quotation sizes, and aggregate quotation sizes from responsible brokers or dealers who are members of such

exchange or association, processing such bids, offers, and sizes, and making such bids, offers, and sizes available to vendors, as follows:

(i) Each national securities exchange shall at all times such exchange is open for trading, collect, process, and make available to vendors the best bid, the best offer, and aggregate quotation sizes for each subject security listed or admitted to unlisted trading privileges which is communicated on any national securities exchange by any responsible broker or dealer, but shall not include:

(A) Any bid or offer executed immediately after communication and any bid or offer communicated by a responsible broker or dealer other than an exchange market maker which is cancelled or withdrawn if not executed immediately after communication; and

(B) Any bid or offer communicated during a period when trading in that security has been suspended or halted, or prior to the commencement of trading in that security on any trading day, on that exchange.

(ii) Each national securities association shall, at all times that last sale information with respect to NMS securities is reported pursuant to an effective transaction reporting plan, collect, process, and make available to vendors the best bid, best offer, and quotation sizes communicated otherwise than on an exchange by each member of such association acting in the capacity of an OTC market maker for each subject security and the identity of that member (excluding any bid or offer executed immediately after communication), except during any period when over-the-counter trading in that security has been suspended.

(2) Each national securities exchange shall, with respect to each published bid and published offer representing a bid or offer of a member for a subject security, establish and maintain procedures for ascertaining and disclosing to other members of that exchange, upon

presentation of orders sought to be executed by them in reliance upon paragraph (b)(2) of this section, the identity of the responsible broker or dealer who made such bid or offer and the quotation size associated with it.

(3)(i) If, at any time a national securities exchange is open for trading, such exchange determines, pursuant to rules approved by the Commission pursuant to section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)), that the level of trading activities or the existence of unusual market conditions is such that the exchange is incapable of collecting, processing, and making available to vendors the data for a subject security required to be made available pursuant to paragraph (a)(1) of this section in a manner that accurately reflects the current state of the market on such exchange, such exchange shall immediately notify all specified persons of that determination. Upon such notification, responsible brokers or dealers that are members of that exchange shall be relieved of their obligation under paragraphs (b)(2) and (c)(3) of this section and such exchange shall be relieved of its obligations under paragraphs (a)(1) and (2) of this section for that security; provided, however, that such exchange will continue, to the maximum extent practicable under the circumstances, to collect, process, and make available to vendors data for that security in accordance with paragraph (a)(1) of this section.

(ii) During any period a national securities exchange, or any responsible broker or dealer that is a member of that exchange, is relieved of any obligation imposed by this section for any subject security by virtue of a notification made pursuant to paragraph (a)(3)(i) of this section, such exchange shall monitor the activity or conditions which formed the basis for such notification and shall immediately renotify all specified persons when that exchange is once again capable of collecting, processing, and making available to vendors the data for that security required to be made available pursuant to paragraph (a)(1) of this section in a manner that

accurately reflects the current state of the market on such exchange. Upon such renotification, any exchange or responsible broker or dealer which had been relieved of any obligation imposed by this section as a consequence of the prior notification shall again be subject to such obligation.

(4) Nothing in this section shall preclude any national securities exchange or national securities association from making available to vendors indications of interest or bids and offers for a subject security at any time such exchange or association is not required to do so pursuant to paragraph (a)(1) of this section.

(5)(i) Any national securities exchange may make an election for purposes of the definition of subject security in § 242.600(b)(71)(i)(B) for any NMS security, by collecting, processing, and making available bids, offers, quotation sizes, and aggregate quotation sizes in that security; except that for any NMS security previously listed or admitted to unlisted trading privileges on only one exchange and not traded by any OTC market maker, such election shall be made by notifying all specified persons, and shall be effective at the opening of trading on the business day following notification.

(ii) Any member of a national securities association acting in the capacity of an OTC market maker may make an election for purposes of the definition of subject security in § 242.600(b)(71)(ii)(B) for any NMS security, by communicating to its association bids, offers, and quotation sizes in that security; except that for any other NMS security listed or admitted to unlisted trading privileges on only one exchange and not traded by any other OTC market maker, such election shall be made by notifying its association and all specified persons, and shall be effective at the opening of trading on the business day following notification.

(iii) The election of a national securities exchange or member of a national securities association for any NMS security pursuant to this paragraph (a)(5) shall cease to be in effect if such exchange or member ceases to make available or communicate bids, offers, and quotation sizes in such security.

(b) Obligations of responsible brokers and dealers.

(1) Each responsible broker or dealer shall promptly communicate to its national securities exchange or national securities association, pursuant to the procedures established by that exchange or association, its best bids, best offers, and quotation sizes for any subject security.

(2) Subject to the provisions of paragraph (b)(3) of this section, each responsible broker or dealer shall be obligated to execute any order to buy or sell a subject security, other than an odd-lot order, presented to it by another broker or dealer, or any other person belonging to a category of persons with whom such responsible broker or dealer customarily deals, at a price at least as favorable to such buyer or seller as the responsible broker's or dealer's published bid or published offer (exclusive of any commission, commission equivalent or differential customarily charged by such responsible broker or dealer in connection with execution of any such order) in any amount up to its published quotation size.

(3)(i) No responsible broker or dealer shall be obligated to execute a transaction for any subject security as provided in paragraph (b)(2) of this section to purchase or sell that subject security in an amount greater than such revised quotation if:

(A) Prior to the presentation of an order for the purchase or sale of a subject security, a responsible broker or dealer has communicated to its exchange or association, pursuant to paragraph (b)(1) of this section, a revised quotation size; or

(B) At the time an order for the purchase or sale of a subject security is presented, a responsible broker or dealer is in the process of effecting a transaction in such subject security, and immediately after the completion of such transaction, it communicates to its exchange or association a revised quotation size, such responsible broker or dealer shall not be obligated by paragraph (b)(2) of this section to purchase or sell that subject security in an amount greater than such revised quotation size.

(ii) No responsible broker or dealer shall be obligated to execute a transaction for any subject security as provided in paragraph (b)(2) of this section if:

(A) Before the order sought to be executed is presented, such responsible broker or dealer has communicated to its exchange or association pursuant to paragraph (b)(1) of this section, a revised bid or offer; or

(B) At the time the order sought to be executed is presented, such responsible broker or dealer is in the process of effecting a transaction in such subject security, and, immediately after the completion of such transaction, such responsible broker or dealer communicates to its exchange or association pursuant to paragraph (b)(1) of this section, a revised bid or offer; provided, however, that such responsible broker or dealer shall nonetheless be obligated to execute any such order in such subject security as provided in paragraph (b)(2) of this section at its revised bid or offer in any amount up to its published quotation size or revised quotation size.

(4) Subject to the provisions of paragraph (a)(4) of this section:

(i) No national securities exchange or OTC market maker may make available, disseminate or otherwise communicate to any vendor, directly or indirectly, for display on a terminal or other display device any bid, offer, quotation size, or aggregate quotation size for any

NMS security which is not a subject security with respect to such exchange or OTC market maker; and

(ii) No vendor may disseminate or display on a terminal or other display device any bid, offer, quotation size, or aggregate quotation size from any national securities exchange or OTC market maker for any NMS security which is not a subject security with respect to such exchange or OTC market maker.

(5)(i) Entry of any priced order for an NMS security by an exchange market maker or OTC market maker in that security into an electronic communications network that widely disseminates such order shall be deemed to be:

(A) A bid or offer under this section, to be communicated to the market maker's exchange or association pursuant to this paragraph (b) for at least the minimum quotation size that is required by the rules of the market maker's exchange or association if the priced order is for the account of a market maker, or the actual size of the order up to the minimum quotation size required if the priced order is for the account of a customer; and

(B) A communication of a bid or offer to a vendor for display on a display device for purposes of paragraph (b)(4) of this section.

(ii) An exchange market maker or OTC market maker that has entered a priced order for an NMS security into an electronic communications network that widely disseminates such order shall be deemed to be in compliance with paragraph (b)(5)(i)(A) of this section if the electronic communications network:

(A)(1) Provides to a national securities exchange or national securities association (or an exclusive processor acting on behalf of one or more exchanges or associations) the prices and sizes of the orders at the highest buy price and the lowest sell price for such security entered in,

and widely disseminated by, the electronic communications network by exchange market makers and OTC market makers for the NMS security, and such prices and sizes are included in the quotation data made available by such exchange, association, or exclusive processor to vendors pursuant to this section; and

(2) Provides, to any broker or dealer, the ability to effect a transaction with a priced order widely disseminated by the electronic communications network entered therein by an exchange market maker or OTC market maker that is:

(i) Equivalent to the ability of any broker or dealer to effect a transaction with an exchange market maker or OTC market maker pursuant to the rules of the national securities exchange or national securities association to which the electronic communications network supplies such bids and offers; and

(ii) At the price of the highest priced buy order or lowest priced sell order, or better, for the lesser of the cumulative size of such priced orders entered therein by exchange market makers or OTC market makers at such price, or the size of the execution sought by the broker or dealer, for such security; or

(B) Is an alternative trading system that:

(1) Displays orders and provides the ability to effect transactions with such orders under § 242.301(b)(3); and

(2) Otherwise is in compliance with Regulation ATS (§ 242.300 through § 242.303).

(c) Transactions in listed options.

(1) A national securities exchange or national securities association:

(i) Shall not be required, under paragraph (a) of this section, to collect from responsible brokers or dealers who are members of such exchange or association, or to make

available to vendors, the quotation sizes and aggregate quotation sizes for listed options, if such exchange or association establishes by rule and periodically publishes the quotation size for which such responsible brokers or dealers are obligated to execute an order to buy or sell an options series that is a subject security at its published bid or offer under paragraph (b)(2) of this section;

(ii) May establish by rule and periodically publish a quotation size, which shall not be for less than one contract, for which responsible brokers or dealers who are members of such exchange or association are obligated under paragraph (b)(2) of this section to execute an order to buy or sell a listed option for the account of a broker or dealer that is in an amount different from the quotation size for which it is obligated to execute an order for the account of a customer; and

(iii) May establish and maintain procedures and mechanisms for collecting from responsible brokers and dealers who are members of such exchange or association, and making available to vendors, the quotation sizes and aggregate quotation sizes in listed options for which such responsible broker or dealer will be obligated under paragraph (b)(2) of this section to execute an order from a customer to buy or sell a listed option and establish by rule and periodically publish the size, which shall not be less than one contract, for which such responsible brokers or dealers are obligated to execute an order for the account of a broker or dealer.

(2) If, pursuant to paragraph (c)(1) of this section, the rules of a national securities exchange or national securities association do not require its members to communicate to it their quotation sizes for listed options, a responsible broker or dealer that is a member of such exchange or association shall:

(i) Be relieved of its obligations under paragraph (b)(1) of this section to communicate to such exchange or association its quotation sizes for any listed option; and

(ii) Comply with its obligations under paragraph (b)(2) of this section by executing any order to buy or sell a listed option, in an amount up to the size established by such exchange's or association's rules under paragraph (c)(1) of this section.

(3) Thirty second response. Each responsible broker or dealer, within thirty seconds of receiving an order to buy or sell a listed option in an amount greater than the quotation size established by a national securities exchange's or national securities association's rules pursuant to paragraph (c)(1) of this section, or its published quotation size must:

(i) Execute the entire order; or

(ii)(A) Execute that portion of the order equal to at least:

(1) The quotation size established by a national securities exchange's or national securities association's rules, pursuant to paragraph (c)(1) of this section, to the extent that such exchange or association does not collect and make available to vendors quotation size and aggregate quotation size under paragraph (a) of this section; or

(2) Its published quotation size; and

(B) Revise its bid or offer.

(4) Notwithstanding paragraph (c)(3) of this section, no responsible broker or dealer shall be obligated to execute a transaction for any listed option as provided in paragraph (b)(2) of this section if:

(i) Any of the circumstances in paragraph (b)(3) of this section exist; or

(ii) The order for the purchase or sale of a listed option is presented during a trading rotation in that listed option.

(d) Exemptions. The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any responsible broker or dealer, electronic communications network, national securities exchange, or national securities association if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system.

§ 242.603 Distribution, consolidation, and display of information with respect to quotations for and transactions in NMS stocks.

(a) Distribution of information.

(1) Any exclusive processor, or any broker or dealer with respect to information for which it is the exclusive source, that distributes information with respect to quotations for or transactions in an NMS stock to a securities information processor shall do so on terms that are fair and reasonable.

(2) Any national securities exchange, national securities association, broker, or dealer that distributes information with respect to quotations for or transactions in an NMS stock to a securities information processor, broker, dealer, or other persons shall do so on terms that are not unreasonably discriminatory.

(b) Consolidation of information. Every national securities exchange on which an NMS stock is traded and national securities association shall act jointly pursuant to one or more effective national market system plans to disseminate consolidated information, including a national best bid and national best offer, on quotations for and transactions in NMS stocks. Such plan or plans shall provide for the dissemination of all consolidated information for an individual NMS stock through a single plan processor.

(c) Display of information.

(1) No securities information processor, broker, or dealer shall provide, in a context in which a trading or order-routing decision can be implemented, a display of any information with respect to quotations for or transactions in an NMS stock without also providing, in an equivalent manner, a consolidated display for such stock.

(2) The provisions of paragraph (c)(1) of this section shall not apply to a display of information on the trading floor or through the facilities of a national securities exchange or to a display in connection with the operation of a market linkage system implemented in accordance with an effective national market system plan.

(d) Exemptions. The Commission, by order, may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any person, security, or item of information, or any class or classes of persons, securities, or items of information, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

§ 242.604 Display of customer limit orders.

(a) Specialists and OTC market makers. For all NMS stocks:

(1) Each member of a national securities exchange that is registered by that exchange as a specialist, or is authorized by that exchange to perform functions substantially similar to that of a specialist, shall publish immediately a bid or offer that reflects:

(i) The price and the full size of each customer limit order held by the specialist that is at a price that would improve the bid or offer of such specialist in such security; and

(ii) The full size of each customer limit order held by the specialist that:

(A) Is priced equal to the bid or offer of such specialist for such security;

(B) Is priced equal to the national best bid or national best offer; and

(C) Represents more than a de minimis change in relation to the size associated with the specialist's bid or offer.

(2) Each registered broker or dealer that acts as an OTC market maker shall publish immediately a bid or offer that reflects:

(i) The price and the full size of each customer limit order held by the OTC market maker that is at a price that would improve the bid or offer of such OTC market maker in such security; and

(ii) The full size of each customer limit order held by the OTC market maker that:

(A) Is priced equal to the bid or offer of such OTC market maker for such security;

(B) Is priced equal to the national best bid or national best offer; and

(C) Represents more than a de minimis change in relation to the size associated with the OTC market maker's bid or offer.

(b) Exceptions. The requirements in paragraph (a) of this section shall not apply to any customer limit order:

(1) That is executed upon receipt of the order.

(2) That is placed by a customer who expressly requests, either at the time that the order is placed or prior thereto pursuant to an individually negotiated agreement with respect to such customer's orders, that the order not be displayed.

(3) That is an odd-lot order.

(4) That is a block size order, unless a customer placing such order requests that the order be displayed.

(5) That is delivered immediately upon receipt to a national securities exchange or national securities association-sponsored system, or an electronic communications network that complies with the requirements of § 242.602(b)(5)(ii) with respect to that order.

(6) That is delivered immediately upon receipt to another exchange member or OTC market maker that complies with the requirements of this section with respect to that order.

(7) That is an "all or none" order.

(c) Exemptions. The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any responsible broker or dealer, electronic communications network, national securities exchange, or national securities association if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system.

§ 242.605 Disclosure of order execution information.

Preliminary Note: Section 242.605 requires market centers to make available standardized, monthly reports of statistical information concerning their order executions. This information is presented in accordance with uniform standards that are based on broad assumptions about order execution and routing practices. The information will provide a starting point to promote visibility and competition on the part of market centers and broker-dealers, particularly on the factors of execution price and speed. The disclosures required by this section do not encompass all of the factors that may be important to investors in evaluating the order routing services of a broker-dealer. In addition, any particular market center's statistics will encompass varying types of orders routed by different broker-dealers on behalf of customers with a wide range of objectives. Accordingly, the statistical information required by this section

alone does not create a reliable basis to address whether any particular broker-dealer failed to obtain the most favorable terms reasonably available under the circumstances for customer orders.

(a) Monthly electronic reports by market centers.

(1) Every market center shall make available for each calendar month, in accordance with the procedures established pursuant to paragraph (a)(2) of this section, a report on the covered orders in NMS stocks that it received for execution from any person. Such report shall be in electronic form; shall be categorized by security, order type, and order size; and shall include the following columns of information:

(i) For market orders, marketable limit orders, inside-the-quote limit orders, at-the-quote limit orders, and near-the-quote limit orders:

(A) The number of covered orders;

(B) The cumulative number of shares of covered orders;

(C) The cumulative number of shares of covered orders cancelled prior to execution;

(D) The cumulative number of shares of covered orders executed at the receiving market center;

(E) The cumulative number of shares of covered orders executed at any other venue;

(F) The cumulative number of shares of covered orders executed from 0 to 9 seconds after the time of order receipt;

(G) The cumulative number of shares of covered orders executed from 10 to 29 seconds after the time of order receipt;

(H) The cumulative number of shares of covered orders executed from 30 seconds to 59 seconds after the time of order receipt;

(I) The cumulative number of shares of covered orders executed from 60 seconds to 299 seconds after the time of order receipt;

(J) The cumulative number of shares of covered orders executed from 5 minutes to 30 minutes after the time of order receipt; and

(K) The average realized spread for executions of covered orders; and

(ii) For market orders and marketable limit orders:

(A) The average effective spread for executions of covered orders;

(B) The cumulative number of shares of covered orders executed with price improvement;

(C) For shares executed with price improvement, the share-weighted average amount per share that prices were improved;

(D) For shares executed with price improvement, the share-weighted average period from the time of order receipt to the time of order execution;

(E) The cumulative number of shares of covered orders executed at the quote;

(F) For shares executed at the quote, the share-weighted average period from the time of order receipt to the time of order execution;

(G) The cumulative number of shares of covered orders executed outside the quote;

(H) For shares executed outside the quote, the share-weighted average amount per share that prices were outside the quote; and

(I) For shares executed outside the quote, the share-weighted average period from the time of order receipt to the time of order execution.

(2) Every national securities exchange on which NMS stocks are traded and each national securities association shall act jointly in establishing procedures for market centers to

follow in making available to the public the reports required by paragraph (a)(1) of this section in a uniform, readily accessible, and usable electronic form. In the event there is no effective national market system plan establishing such procedures, market centers shall prepare their reports in a consistent, usable, and machine-readable electronic format, and make such reports available for downloading from an Internet website that is free and readily accessible to the public.

(3) A market center shall make available the report required by paragraph (a)(1) of this section within one month after the end of the month addressed in the report.

(b) Exemptions. The Commission may, by order upon application, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this section, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

§ 242.606 Disclosure of order routing information.

(a) Quarterly report on order routing.

(1) Every broker or dealer shall make publicly available for each calendar quarter a report on its routing of non-directed orders in NMS securities during that quarter. For NMS stocks, such report shall be divided into three separate sections for securities that are listed on the New York Stock Exchange, Inc., securities that are qualified for inclusion in The Nasdaq Stock Market, Inc., and securities that are listed on the American Stock Exchange LLC or any other national securities exchange. Such report also shall include a separate section for NMS securities that are option contracts. Each of the four sections in a report shall include the following information:

(i) The percentage of total customer orders for the section that were non-directed orders, and the percentages of total non-directed orders for the section that were market orders, limit orders, and other orders;

(ii) The identity of the ten venues to which the largest number of total non-directed orders for the section were routed for execution and of any venue to which five percent or more of non-directed orders were routed for execution, the percentage of total non-directed orders for the section routed to the venue, and the percentages of total non-directed market orders, total non-directed limit orders, and total non-directed other orders for the section that were routed to the venue; and

(iii) A discussion of the material aspects of the broker's or dealer's relationship with each venue identified pursuant to paragraph (a)(1)(ii) of this section, including a description of any arrangement for payment for order flow and any profit-sharing relationship.

(2) A broker or dealer shall make the report required by paragraph (a)(1) of this section publicly available within one month after the end of the quarter addressed in the report.

(b) Customer requests for information on order routing.

(1) Every broker or dealer shall, on request of a customer, disclose to its customer the identity of the venue to which the customer's orders were routed for execution in the six months prior to the request, whether the orders were directed orders or non-directed orders, and the time of the transactions, if any, that resulted from such orders.

(2) A broker or dealer shall notify customers in writing at least annually of the availability on request of the information specified in paragraph (b)(1) of this section.

(c) Exemptions. The Commission may, by order upon application, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons,

securities, or transactions, from any provision or provisions of this section, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

§ 242.607 Customer account statements.

(a) No broker or dealer acting as agent for a customer may effect any transaction in, induce or attempt to induce the purchase or sale of, or direct orders for purchase or sale of, any NMS stock or a security authorized for quotation on an automated inter-dealer quotation system that has the characteristics set forth in section 17B of the Act (15 U.S.C. 78q-2), unless such broker or dealer informs such customer, in writing, upon opening a new account and on an annual basis thereafter, of the following:

(1) The broker's or dealer's policies regarding receipt of payment for order flow from any broker or dealer, national securities exchange, national securities association, or exchange member to which it routes customers' orders for execution, including a statement as to whether any payment for order flow is received for routing customer orders and a detailed description of the nature of the compensation received; and

(2) The broker's or dealer's policies for determining where to route customer orders that are the subject of payment for order flow absent specific instructions from customers, including a description of the extent to which orders can be executed at prices superior to the national best bid and national best offer.

(b) Exemptions. The Commission, upon request or upon its own motion, may exempt by rule or by order, any broker or dealer or any class of brokers or dealers, security or class of securities from the requirements of paragraph (a) of this section with respect to any transaction or class of transactions, either unconditionally or on specified terms and conditions, if

the Commission determines that such exemption is consistent with the pubic interest and the protection of investors.

§ 242.608 Filing and amendment of national market system plans.

(a) Filing of national market system plans and amendments thereto.

(1) Any two or more self-regulatory organizations, acting jointly, may file a national market system plan or may propose an amendment to an effective national market system plan ("proposed amendment") by submitting the text of the plan or amendment to the Secretary of the Commission, together with a statement of the purpose of such plan or amendment and, to the extent applicable, the documents and information required by paragraphs (a)(4) and (5) of this section.

(2) The Commission may propose amendments to any effective national market system plan by publishing the text thereof, together with a statement of the purpose of such amendment, in accordance with the provisions of paragraph (b) of this section.

(3) Self-regulatory organizations are authorized to act jointly in:

(i) Planning, developing, and operating any national market subsystem or facility contemplated by a national market system plan;

(ii) Preparing and filing a national market system plan or any amendment thereto; or

(iii) Implementing or administering an effective national market system plan.

(4) Every national market system plan filed pursuant to this section, or any amendment thereto, shall be accompanied by:

(i) Copies of all governing or constituent documents relating to any person (other than a self-regulatory organization) authorized to implement or administer such plan on behalf of its sponsors; and

(ii) To the extent applicable:

(A) A detailed description of the manner in which the plan or amendment, and any facility or procedure contemplated by the plan or amendment, will be implemented;

(B) A listing of all significant phases of development and implementation (including any pilot phase) contemplated by the plan or amendment, together with the projected date of completion of each phase;

(C) An analysis of the impact on competition of implementation of the plan or amendment or of any facility contemplated by the plan or amendment;

(D) A description of any written understandings or agreements between or among plan sponsors or participants relating to interpretations of the plan or conditions for becoming a sponsor or participant in the plan; and

(E) In the case of a proposed amendment, a statement that such amendment has been approved by the sponsors in accordance with the terms of the plan.

(5) Every national market system plan, or any amendment thereto, filed pursuant to this section shall include a description of the manner in which any facility contemplated by the plan or amendment will be operated. Such description shall include, to the extent applicable:

(i) The terms and conditions under which brokers, dealers, and/or self-regulatory organizations will be granted or denied access (including specific procedures and standards governing the granting or denial of access);

(ii) The method by which any fees or charges collected on behalf of all of the sponsors and/or participants in connection with access to, or use of, any facility contemplated by the plan or amendment will be determined and imposed (including any provision for distribution

of any net proceeds from such fees or charges to the sponsors and/or participants) and the amount of such fees or charges;

(iii) The method by which, and the frequency with which, the performance of any person acting as plan processor with respect to the implementation and/or operation of the plan will be evaluated; and

(iv) The method by which disputes arising in connection with the operation of the plan will be resolved.

(6) In connection with the selection of any person to act as plan processor with respect to any facility contemplated by a national market system plan (including renewal of any contract for any person to so act), the sponsors shall file with the Commission a statement identifying the person selected, describing the material terms under which such person is to serve as plan processor, and indicating the solicitation efforts, if any, for alternative plan processors, the alternatives considered and the reasons for selection of such person.

(7) Any national market system plan (or any amendment thereto) which is intended by the sponsors to satisfy a plan filing requirement contained in any other section of this Regulation NMS and part 240, subpart A of this chapter shall, in addition to compliance with this section, also comply with the requirements of such other section.

(b) Effectiveness of national market system plans.

(1) The Commission shall publish notice of the filing of any national market system plan, or any proposed amendment to any effective national market system plan (including any amendment initiated by the Commission), together with the terms of substance of the filing or a description of the subjects and issues involved, and shall provide interested persons an opportunity to submit written comments. No national market system plan, or any amendment

thereto, shall become effective unless approved by the Commission or otherwise permitted in accordance with paragraph (b)(3) of this section.

(2) Within 120 days of the date of publication of notice of filing of a national market system plan or an amendment to an effective national market system plan, or within such longer period as the Commission may designate up to 180 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or as to which the sponsors consent, the Commission shall approve such plan or amendment, with such changes or subject to such conditions as the Commission may deem necessary or appropriate, if it finds that such plan or amendment is necessary or appropriate in the public interest, for the protection of investors and the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanisms of, a national market system, or otherwise in furtherance of the purposes of the Act. Approval of a national market system plan, or an amendment to an effective national market system plan (other than an amendment initiated by the Commission), shall be by order. Promulgation of an amendment to an effective national market system plan initiated by the Commission shall be by rule.

(3) A proposed amendment may be put into effect upon filing with the Commission if designated by the sponsors as:

(i) Establishing or changing a fee or other charge collected on behalf of all of the sponsors and/or participants in connection with access to, or use of, any facility contemplated by the plan or amendment (including changes in any provision with respect to distribution of any net proceeds from such fees or other charges to the sponsors and/or participants);

(ii) Concerned solely with the administration of the plan, or involving the governing or constituent documents relating to any person (other than a self-regulatory organization) authorized to implement or administer such plan on behalf of its sponsors; or

(iii) Involving solely technical or ministerial matters. At any time within 60 days of the filing of any such amendment, the Commission may summarily abrogate the amendment and require that such amendment be refiled in accordance with paragraph (a)(1) of this section and reviewed in accordance with paragraph (b)(2) of this section, if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanisms of, a national market system or otherwise in furtherance of the purposes of the Act.

(4) Notwithstanding the provisions of paragraph (b)(1) of this section, a proposed amendment may be put into effect summarily upon publication of notice of such amendment, on a temporary basis not to exceed 120 days, if the Commission finds that such action is necessary or appropriate in the public interest, for the protection of investors or the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanisms of, a national market system or otherwise in furtherance of the purposes of the Act.

(5) Any plan (or amendment thereto) in connection with:

(i) The planning, development, operation, or regulation of a national market system (or a subsystem thereof) or one or more facilities thereof; or

(ii) The development and implementation of procedures and/or facilities designed to achieve compliance by self-regulatory organizations and/or their members of any section of this Regulation NMS and part 240, subpart A of this chapter promulgated pursuant to section 11A of the Act (15 U.S.C. 78k-1), approved by the Commission pursuant to section 11A of the Act (or

pursuant to any rule or regulation thereunder) prior to the effective date of this section (either temporarily or permanently) shall be deemed to have been filed and approved pursuant to this section and no additional filing need be made by the sponsors with respect to such plan or amendment; provided, however, that all terms and conditions associated with any such approval (including time limitations) shall continue to be applicable; provided, further, that any amendment to such plan filed with or approved by the Commission on or after the effective date of this section shall be subject to the provisions of, and considered in accordance with the procedures specified in, this section.

(c) Compliance with terms of national market system plans. Each self-regulatory organization shall comply with the terms of any effective national market system plan of which it is a sponsor or a participant. Each self-regulatory organization also shall, absent reasonable justification or excuse, enforce compliance with any such plan by its members and persons associated with its members.

(d) Appeals. The Commission may, in its discretion, entertain appeals in connection with the implementation or operation of any effective national market system plan as follows:

(1) Any action taken or failure to act by any person in connection with an effective national market system plan (other than a prohibition or limitation of access reviewable by the Commission pursuant to section 11A(b)(5) or section 19(d) of the Act (15 U.S.C. 78k-1(b)(5) or 78s(d))) shall be subject to review by the Commission, on its own motion or upon application by any person aggrieved thereby (including, but not limited to, self-regulatory organizations, brokers, dealers, issuers, and vendors), filed not later than 30 days after notice of such action or failure to act or within such longer period as the Commission may determine.

(2) Application to the Commission for review, or the institution of review by the Commission on its own motion, shall not operate as a stay of any such action unless the Commission determines otherwise, after notice and opportunity for hearing on the question of a stay (which hearing may consist only of affidavits or oral arguments).

(3) In any proceedings for review, if the Commission, after appropriate notice and opportunity for hearing (which hearing may consist solely of consideration of the record of any proceedings conducted in connection with such action or failure to act and an opportunity for the presentation of reasons supporting or opposing such action or failure to act) and upon consideration of such other data, views, and arguments as it deems relevant, finds that the action or failure to act is in accordance with the applicable provisions of such plan and that the applicable provisions are, and were, applied in a manner consistent with the public interest, the protection of investors, the maintenance of fair and orderly markets, and the removal of impediments to, and the perfection of the mechanisms of a national market system, the Commission, by order, shall dismiss the proceeding. If the Commission does not make any such finding, or if it finds that such action or failure to act imposes any burden on competition not necessary or appropriate in furtherance of the purposes of the Act, the Commission, by order, shall set aside such action and/or require such action with respect to the matter reviewed as the Commission deems necessary or appropriate in the public interest, for the protection of investors, and the maintenance of fair and orderly markets, or to remove impediments to, and perfect the mechanisms of, a national market system.

(e) Exemptions. The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any self-regulatory organization, member thereof, or specified security, if the Commission determines that such exemption is

consistent with the public interest, the protection of investors, the maintenance of fair and orderly markets and the removal of impediments to, and perfection of the mechanisms of, a national market system.

§ 242.609 Registration of securities information processors: form of application and amendments.

(a) An application for the registration of a securities information processor shall be filed on Form SIP (§ 249.1001) in accordance with the instructions contained therein.

(b) If any information reported in items 1-13 or item 21 of Form SIP or in any amendment thereto is or becomes inaccurate for any reason, whether before or after the registration has been granted, the securities information processor shall promptly file an amendment on Form SIP correcting such information.

(c) The Commission, upon its own motion or upon application by any securities information processor, may conditionally or unconditionally exempt any securities information processor from any provision of the rules or regulations adopted under section 11A(b) of the Act (15 U.S.C. 78k-1(b)).

(d) Every amendment filed pursuant to this section shall constitute a "report" within the meaning of sections 17(a), 18(a) and 32(a) of the Act (15 U.S.C. 78q(a), 78r(a), and 78ff(a)).

§ 242.610 Access to published bids and offers.

(a) Requirements.

(1) A quoting market center shall not impose unfairly discriminatory terms that prevent or inhibit a non-member, non-customer, or non-subscriber of the quoting market center from obtaining access to quotations and the execution of orders through a member, customer, or subscriber of the quoting market center.

(2) A quoting market participant:

(i) Shall make its quotations available, for the purpose of order execution, to all other quoting market participants and all quoting market centers on terms as favorable as those it grants to its most preferred member, customer, or subscriber; and

(ii) Shall not impose unfairly discriminatory terms that prevent or inhibit a non-member, non-customer, or non-subscriber of the quoting market participant from obtaining access to quotations and the execution of orders through a member, customer, or subscriber of the quoting market participant.

(b) Quotation standardization.

(1) A quoting market center may impose a fee for an order execution against its displayed price in an amount no greater than:

(i) $.001 per share; or

(ii) .1% of price per share in the case of a security with a share price of less than $1.00.

(2) A quoting market participant may impose a fee for an order execution against its displayed price in an amount no greater than:

(i) $.001 per share; or

(ii) .1% of price per share in the case of a security with a share price of less than $1.00.

(3) A broker-dealer that displays an attributable quote through a quoting market center may impose a fee for the execution of an order against such displayed attributable quote in an amount no greater than:

(i) $.001 per share; or

(ii) .1% of price per share in the case of a security with a share price of less than $1.00.

(4) Accumulated access fees of quoting market centers, quoting market participants, and broker-dealers shall not exceed $.002 per share in any transaction; for securities priced at less than $1.00, such fees shall not exceed .2% of the share price.

(c) Locked or crossed quotations.

Each national securities exchange and national securities association must establish and enforce rules:

(1) That require its members reasonably to avoid locking or crossing the quotations of quoting market centers and quoting market participants;

(2) That are reasonably designed to enable a market participant to reconcile locked or crossed quotations in a security before effecting a trade in that security; and

(3) That prohibit its members from engaging in a pattern or practice of locking or crossing quotations in any security.

(d) Exemptions. The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any national securities exchange, national securities association, quoting market center, or quoting market participant if the Commission determines that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.

§ 242.611 Trade-through rule.

(a) Price protection.

(1) An order execution facility, national securities exchange, and national securities association must establish, maintain, and enforce policies and procedures reasonably designed to

prevent the execution of a trade-through in its market, unless one or more of the provisions of paragraph (b) of this section is applicable.

(2) An order execution facility, national securities exchange, and national securities association that is not able to or chooses not to comply with the requirements of paragraph (a)(1) of this section may only accept orders that are opted-out pursuant to paragraph (b)(8) of this section.

(b) Exceptions. The policies and procedures required by paragraph (a) of this section do not have to be designed to prevent the execution of a trade-through in the following circumstances:

(1) The order execution facility displaying the better price was experiencing a failure, material delay, or malfunction of its systems or equipment when the trade-through occurred.

(2) The order execution facility that initiated the trade-through made every reasonable effort to avoid the trade-through but was unable to do so because of a systems or equipment failure, material delay, or malfunction in its own market.

(3) The transaction that constituted the trade-through was not a "regular way" contract.

(4) The bid or offer that is traded-through was displayed by an order execution facility that was, or whose members were, relieved of their obligations under § 242.602(b)(2) with respect to such bid or offer pursuant to § 242.602(a)(3).

(5) The transaction that constituted the trade-through was an opening or reopening transaction by the order execution facility.

(6) The transaction that constituted the trade-through was executed at a time when there was a crossed market.

(7)(i) At the same time or prior to executing a transaction that constituted a trade-through, the order execution facility sent an order or orders to trade with each bid or offer of another order execution facility that was disseminated pursuant to an effective national market system plan and that was priced better than the price at which such transaction was executed ("better-priced bid or offer").

(ii) Each order sent by an order execution facility under paragraph (b)(7)(i) of this section must be priced equal to or better than the better-priced bid or offer and be for the number of shares displayed for that better-priced bid or offer.

(8) Opt-out orders. When a broker or dealer or a customer expressly provides, at the time an order is placed for its account, informed consent to the execution of such order without regard to a better price of another order execution facility that is disseminated pursuant to an effective national market system plan.

(9) Automated order execution facilities.

(i) An automated order execution facility can trade through the best bid or best offer of a non-automated order execution facility that is disseminated pursuant to an effective national market system plan up to the trade-through limit amount.

(ii) For a buy order in an NMS stock where the national best offer is under $10 at the time of execution, or a sell order in an NMS stock where the national best bid is under $10 at the time of execution, the trade-through limit amount is equal to one cent.

(iii) For a buy order in an NMS stock where the national best offer is from $10.01 to $30 at the time of execution, or a sell order in an NMS stock where the national best bid is from $10.01 to $30 at the time of execution, the trade-through limit amount is equal to two cents.

(iv) For a buy order in an NMS stock where the national best offer is from $30.01 to $50 at the time of execution, or a sell order in an NMS stock where the national best bid is from $30.01 to $50 at the time of execution, the trade-through limit amount is equal to three cents.

(v) For a buy order in an NMS stock where the national best offer is from $50.01 to $100 at the time of execution, or a sell order in an NMS stock where the national best bid is from $50.01 to $100 at the time of execution, the trade-through limit amount is equal to four cents.

(vi) For a buy order in an NMS stock where the national best offer is greater than $100 at the time of execution, or a sell order in an NMS stock where the national best bid is greater than $100 at the time of execution, the trade-through limit amount is equal to five cents.

(c) Disclosure requirement to customers that opt-out.

(1) For each buy order for the account of a customer executed pursuant to paragraph (b)(8) of this section, the broker or dealer must disclose to the customer the national best offer for the NMS stock at the time of execution of the order. For each sell order for the account of a customer executed pursuant to paragraph (b)(8) of this section, the broker or dealer must disclose to the customer the national best bid for the NMS stock at the time of execution of the order.

(2) The bid or offer required to be disclosed pursuant to paragraph (c)(1) of this section must be disclosed as soon as possible, but in no event later than one month from the date on which the order was executed.

(3) The bid or offer required to be disclosed pursuant to paragraph (c)(1) of this section must be displayed in close proximity to, and no less prominently than, the execution price as reported to the customer for the order pursuant to the requirements of § 240.10b-10 of this chapter.

(d) Exemptions. The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any order execution facility, national securities exchange, national securities association, or broker or dealer if the Commission determines that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.

§ 242.612 Minimum pricing increment.

(a) No national securities exchange, national securities association, alternative trading system, vendor, or broker or dealer shall display, rank, or accept from any person a bid or offer, an order, or an indication of interest in any NMS stock priced in an increment less than $0.01, except for those NMS stocks the share price of which is below $1.00.

(b) Exemptions. The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any organization, association, or group of persons if the Commission determines that such exemption is consistent with the public interest, the protection of investors, the maintenance of fair and orderly markets, or the removal of impediments to and the perfection of the mechanism of a national market system.

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

25. The authority citation for part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a et seq. and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

26. Section 249.1001 is revised to read as follows:

§ 249.1001 Form SIP, for application for registration as a securities information processor or to amend such an application or registration.

This form shall be used for application for registration as a securities information processor, pursuant to section 11A(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78k-1(b)) and § 242.609 of this chapter, or to amend such an application or registration.

27. Form SIP (referenced in § 249.1001) is amended by revising Instruction 6 of General Instructions for Preparing and Filing Form SIP to read as follows:

FORM SIP

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GENERAL INSTRUCTIONS FOR PREPARING AND FILING FORM SIP

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6. Rule 609(b) of Regulation NMS requires that if any information contained in items 1 through 13 or item 21 of this application, or any supplement or amendment thereto, is or becomes inaccurate for any reason, an amendment must be filed promptly on Form SIP correcting such information.

* * * * *

By the Commission.

Margaret H. McFarland
Deputy Secretary

Dated: February 26, 2004