ARCHIPELAGO PROPOSAL TO MODERNIZE THE NATIONAL MARKET SYSTEM

"Sunlight is the best disinfectant; electric light, the best policeman." - L. D. Brandeis

"We propose to move faster." - H. P. Long, Jr.

I. INTRODUCTION

Throughout the 1960s, both Congress and the Securities and Exchange Commission ("SEC" or "Commission") struggled with the lack of informational linkage between trading venues for securities listed on a National Securities Exchange ("Exchange"), or traded over-the-counter ("OTC") under the regulatory auspices of the National Association of Securities Dealers, Inc. ("NASD"), the lone National Securities Association ("NSA").[1] The OTC marketplace operated without formal, automated linkage, and trading in Exchange-listed securities occurred in multiple locations without regard to all available prices.[2] As a solution to these problems of fragmentation, the notion of a National Market System, or "NMS," to link trading venues—in terms of both a market information linkage and a regulatory structure—was borne.

To build the NMS, Congress amended the Exchange Act in 1975 to erect a system of market linkages that would assure: fair competition among broker-dealers and exchanges; investor access to quotation and transaction information; and, the ability of brokers to execute investor orders in the best market.[3] During the years that followed, market participants worked with the Commission to create a number of inter-market plans in furtherance of the NMS vision–including the Intermarket Trading System ("ITS"), the Consolidated Tape/Quote Association ("CTA/CQ"), and the NASDAQ/National Market System/Unlisted Trading Privileges Plan ("OTC-UTP"). In addition, a new entity was added to buttress the new NMS structure: the Securities Information Processor ("SIP").

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[1] Exchanges and NSAs register and operate as self-regulatory organizations ("SROs") in accordance with Sections 6 and 15A of the Securities Exchange Act of 1934 ("Exchange Act"), respectively.

[2] The Commission remedied deficiencies in the OTC marketplace by calling for the creation of the NASD Automated Quotation system ("NASDAQ") that was completed by the Bunker-Ramo Corporation, on behalf of the NASD, in 1971. (See Report of Special Study of Securities Markets, SEC, 1963 ("Special Study") (discussing the deficiencies of the OTC marketplace before NASDAQ.)) NASDAQ now provides informational linkage for over 5,200 OTC securities. For the purposes of this document, the term "OTC security" shall refer to a NASDAQ-listed OTC security.

[3] Section 11A(a)(1)(C) of the Exchange Act.

For over twenty years now, little about these plans has changed or progressed, despite enormous marketplace change and revolutionary advances in technology that afford many opportunities for substantial improvements. Without question, the time has come for a fundamental review of NMS-related structures to assure that these pose no competitive or technological constraints on an effective NMS, the benefits of which directly accrue to the investing public.

Archipelago, L.L.C. ("Archipelago") believes that the NMS concept remains as fundamentally sound as it was 1975, but that the associated plans and structures need substantial improvement.[4] Below, Archipelago sets forth a high-level design for an improved NMS for both Exchange-listed and OTC securities ("Archipelago Proposal" or "Proposal"). The Proposal, we believe, maintains the baseline benefits of the current NMS structure, but builds on the status quo by serving investors through: (1) eliminating the troubling conflicts of interest inherent in today's NMS structures; and, (2) encouraging innovation and competition. The resulting improvements will directly benefit investors by reducing trading costs, improving transparency, and increasing market efficiency.

The Archipelago Proposal is structured as follows: first, it sets forth a broad outline of a next-generation NMS; second, it addresses and analyzes in detail the specific components thereof; and, third, it establishes the implementation necessary to change the marketplace for OTC securities.[5]

[4] Archipelago is a broker-dealer that operates an electronic communications network ("ECN"). Archipelago currently executes nearly 5% of volume transacted in OTC securities and participates in NMS structures for Exchange-listed securities via the NASD.

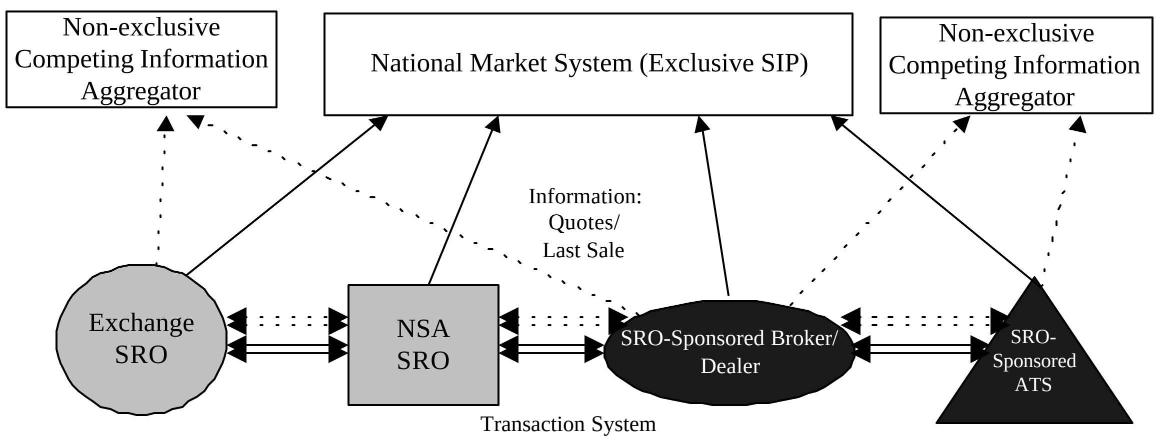
[5] Although it applies to both Exchange-listed and OTC securities, the Proposal suggests an implementation approach for OTC securities because that marketplace is currently embroiled in controversy that should be addressed as soon as possible. <u>See</u> Section V, <u>infra</u>. As Archipelago refines its Proposal, we will provide detailed suggestions relating to implementation for Exchange-listed securities.

II. THE ARCHIPELAGO PROPOSAL: GENERAL FRAMEWORK

Under the Proposal, the NMS provides a framework wherein competing market centers reflect trading interest through quotations and access the quotations of other participant market centers. Moreover, the NMS gives multiple venues the ability to obtain and sell market information, thus giving rise to competitively-determined market data rates. To preserve the integrity of the marketplace, participants must adhere to established rules of just and equitable principles of trade, as promulgated—and enforced—by both the NMS and SEC.

Figure 1 illustrates the general structure for the proposed national market system, including linkage and participation.

Figure 1: Proposed National Market System



The next-generation NMS would be based on five guiding principles: (1) transparent information; (2) neutral control and workable governance; (3) effective regulation; (4) open participation; and, (5) incentive-driven technological deployment.

1. Transparent Information. Under the Proposal, an exclusive securities information processor ("Exclusive SIP") collects information, at least until such time as such an entity is no longer necessary to assure information consolidation. Like today, all market centers that trade a security covered by an NMS plan will be required to submit real-time best quotation (or "top of book") and last-sale information to the Exclusive SIP associated with that plan (denoted by single solid lines in Figure 1).[6]

Unlike today, however, market participants would also be permitted, if not encouraged, to disseminate this information—and, perhaps additional information, such

[6] Pursuant to Rule 11Ac1-1 under the Act.

as full depth of book—to a non-exclusive, competing information collector ("Information Collector") (denoted by single dotted lines in Figure 1). Information Collectors would be permitted to purchase information from market participants at market-determined rates and, in turn, to sell such information to vendors at market-determined rates, based on the value of the information.

Although the Exclusive SIP would, in essence, compete with Information Collectors, any information collected through the Exclusive SIP network would be disseminated to all market participants on a non-discriminatory basis, including competing Information Collectors. Further, the ability to contract for information above and beyond last sale and best quotation information—the purview of the Exclusive SIP—would provide a valuable incentive for Information Collectors. Indeed, a number of entities have already begun to provide this type of service to the OTC marketplace as vendors. [7]

In addition, the Exclusive SIP would be responsible to supply a linkage system to access market participant quotations (denoted by double solid lines in Figure 1). This system would serve to preserve the integrity of quotations and facilitate trading among market centers. In addition to the Exclusive SIP-sponsored linkage system, market participants would be permitted to build proprietary transaction linkages outside of the Exclusive SIP linkage system (denoted by double dotted lines in Figure 1). Such linkages assure redundancy and eliminate "single point of failure" deficiencies of anachronistic hub-and-spoke models. [8]

2. Neutral Control and Workable Governance. A committee, consisting of any SRO that agrees to terms of membership in the NMS plan and participation in the Exclusive SIP, would govern the operations thereof ("Governing Committee"). The Governing Committee will be responsible for establishing marketplace rules, including existing and future SEC rulemaking, as well as designating the technology provider. [9] To prevent a single market center from controlling or limiting development for purposes of parochial ends, the Governing Committee would operate on a majority vote basis; no participant would anointed with veto power by way of a unanimity requirement for plan action.

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[7] For example, Yahoo! Finance (http://finance.yahoo.com/), Quotezart (http://www.quotezart.com/), and 3DStockCharts (http://www.3dstockcharts.com) provide real-time, full depth of book for a numb er of ECNs.

[8] In this connection, a number of ECN and market maker participants in the OTC marketplace have built such linkages, which have afforded participants the ability to continue trading during NASDAQ outages. (See Letter from Gerald Putnam, Chief Executive Officer, Archipelago, to Arthur Levitt, Chairman, SEC, dated December 16, 1999)(citing well-documented NASDAQ technological problems, available at http://www.tradearca.com/news_and_views/viewpoints/viewpoint_121699.pdf).

[9] Archipelago envisions a limited set of rules for participation in the NMS, such as provisions for timely trade reporting, firm quotes, and decimal quotation increments. To preserve competition and innovation, plan rules should not be business-model specific.

3. Effective Regulation. Surveillance and enforcement of NMS rules would be handled by a combined effort of participant SROs and the Commission. Regulatory business would be conducted on a self-policing, real-time basis, with SEC involvement where appropriate.

4. Open Participation. All market centers that directly participate in the NMS would have to designate SROs to govern compliance with SEC and plan rules. In other words, an ECN, alternative trading system ("ATS"), or market maker may participate directly in the NMS provided that an SRO "sponsors" that entity by regulating the NMS participation of the sponsored entity. [10]

5. Incentive-Driven Technological Deployment. The Governing Committee would delegate the information and linkage responsibility to a technology provider ("IT Provider"). To ensure that the IT Provider would maintain an efficient, reliable, and cost-effective system, the Governing Committee would solicit competitive bids and select the best respondent in terms of both cost and functionality. In addition, the Governing Committee would periodically audit and evaluate the performance of the IT Provider. As with any other business, the Governing Committee would stand ready to review and accept any proposal to terminate and replace the current IT Provider for reasonable cause, notwithstanding contractual obligations.

[10] Traditionally, the NASD has provided this sponsorship function for market maker and ECN participants in the OTC marketplace. Indeed, as detailed in Section V, infra, an NASD affiliate, NASDAQ, acts as Exclusive SIP for OTC securities. Accordingly, the NASD—or its regulatory affiliate, NASD Regulation, Inc. ("NASDR")—could provide sponsorship services to non-SRO NMS participants, as could the traditional Exchange SROs. Because sponsors could collect sponsorship fees or other consideration, Archipelago anticipates that a number of SROs would provide sponsorship services at competitively-determined rates.

III. DETAILED DESCRIPTION: COMPONENTS OF NMS FRAMEWORK

A. Exclusive SIP and Governing Committee

Under the Proposal, there would be a single NMS plan and Exclusive SIP for each security listed on an Exchange or NSA. [11] The NMS plan and Exclusive SIP would be operated by a Governing Committee, which would be responsible for: (1) NMS marketplace rulemaking; (2) enforcement of marketplace rules; and, (3) technology and information linkage.

The Governing Committee would design and propose rules that govern all trading between market centers participating directly in the Exclusive SIP. [12] The Governing Committee would submit all rule changes to the Commission for approval, subject to the standard public notice and comment period. [13]

With "rules" come the need for enforcement and its associated apparatus; the absence of such a framework would render Governing Committee rulemaking and rules meaningless. Two options for inter-market regulation are feasible. First, the Governing Committee could designate a single regulator, giving it jurisdiction over all inter-market transactions, including those affected by way of NMS linkage as well as external competing linkages.

Alternatively, each participating SRO could be responsible for regulating its own compliance with NMS rules, in addition to the compliance of any counterparty SRO in inter-market transactions. If a participating SRO determines that another market center is not complying with NMS rules, the SRO could attempt to resolve the conflict with the violating SRO. [14] Failing resolution, the SRO would refer alleged violations to the SEC for further action. Archipelago believes that, at present, the latter option is more

[11] Archipelago envisions either a single NMS plan to cover all Exchange-listed and OTC securities or a separate NMS plans for each listing venue. Archipelago understands that NASDAQ seeks to exempt OTC securities that would be listed on a future "NASDAQ Exchange" from participation in CTA/CQ and ITS, implying that it favors a series of NMS plans based on listing venue. (See letter from Robert Britz, Group Vice President, New York Stock Exchange, Inc. ("NYSE"), to Richard Ketchum, President, NASDAQ, dated October 17, 2000.) Interestingly, the NASDAQ position implies that all OTC securities would list on the "NASDAQ Exchange," which leaves unanswered the question of how the NASD would intend to fulfill its Congressional and SEC mandate to organize the OTC marketplace, as set forth in 1963 via the Special Study.

[12] Exclusive SIP rules would be equivalent—in nature—to the current ITS/CTA/CQA and NASDAQ marketplace (NASD Rule 4600-series) rules.

[13] Intermarket plans are held to this standard today.

[14] In the case of non-SRO participants, the sponsoring SRO would be responsible for the foregoing activities.

feasible.[15]

The Governing Committee would be responsible for designating the IT Provider. This entity would be obligated to implement the technology functions required by the Exclusive SIP: information collection and transaction linkage. To ensure a highly efficient and low-cost linkage provider, the Governing Committee should request competing bids from a number of technology providers. These bids should consist of a detailed description of its proposed architecture, system capacity, and cost, among other factors deemed relevant by the Governing Committee.

The chosen IT Provider would be required to meet explicit initial and ongoing standards (as outlined in Section III.D). In addition, the Governing Committee would be required to revisit the performance of the technology provider on a regular periodic basis, perhaps once every two years. During the reevaluation process, the Governing Committee would examine proposals from potential new technology providers vis-à-vis the current provider. This process would inject a competitive environment for Exclusive SIP technology and would serve to maintain a high standard for the NMS technology. The result: processing costs would be contained, as would market data fees.

B. Competing Information Collectors

The NMS would incorporate provisions to enable competitive Information Collectors to develop. Although all market participants would be required to represent their best prices and last-sale information in the NMS, market participants would also be permitted, if not encouraged, to supply information to competing Information Collectors. The Information Collectors would be permitted to sell any information they collect from trading venues at competitively-determined prices.[16] Accordingly, Information Collectors would have economic incentives to improve information dissemination and content relative to the Exclusive SIP.[17] This would lead to price availability beyond the Exclusive SIP should the Exclusive SIP fail to provide all information sought by

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[15] Unfortunately, with the creation of the "NASDAQ Super Montage" while at the same time NASD remains the largest shareholder in NASDAQ, every SRO will be affiliated with an execution venue. Consequently, today no SRO is able to serve as neutral arbiter of inter-market disputes and NMS regulator. Were NASD to completely divest itself of its interest in NASDAQ, however, it may be possible for the NASD and/or NASDR to provide the requisite neutrality.

[16] Importantly, because Non-Exclusive SIPs can derive revenue from sale of data, they would likely proportionally allocate this revenue to the market participants according to the informational value of each. Accordingly, market participants would derive revenue from both the Exclusive SIP and Non-Exclusive SIPs, conditional, of course, on the economic value of that participant's information. Unlike today's revenue sharing schemes, such a competitive market for information would reward those market participants that create informational value without subsidizing those that do not.

[17] Although the Archipelago Proposal contemplates no limits on the content, cost or timeliness of information disseminated by Information Collectors, Archipelago believes enforcement by the Department of Justice and the Federal Trade Commission against predatory pricing practices would prevent market centers from using pricing and/or speed to illegally disadvantage certain classes of information consumers.

investors or market professionals.[18] Likewise, the existence of Information Collectors would encourage the Exclusive SIP technology provider to maintain high standards for information collection and distribution.

The Archipelago Proposal establishes a dynamic system of competing Information Collectors who almost certainly would make the Exclusive SIP unnecessary in the not too distant future; provided, however, that information is not fragmented or degraded in any way because of the elimination of the Exclusive SIP. Further, Archipelago believes that a transition period is appropriate in light of the dynamic economics of information revenue. Indeed, if any single participant were to maintain a near-monopoly of informational content associated with securities subject to an NMS plan, rapid deregulation would have deleterious effects on smaller participants.

C. Non-SRO Participation in NMS

A non-SRO market center would be permitted to display quotation information directly in the Exclusive SIP if it so wished. The SRO medallion should not be a prerequisite to freely display and make accessible trading interest via the NMS. That said, displayed NMS interest, and interactions therewith, must be held accountable and be accorded standardized regulatory treatment. An SRO functions to ensure regulatory accountability for all information represented under its moniker. Consequently, an NMS-participant SRO could appropriately sponsor any non-SRO market center that participates directly in the NMS. The designated SRO would be accountable for any market center that it sponsors.

Archipelago believes that SROs will have considerable incentives to sponsor non-SRO NMS entrants because of the ability to collect fees for this service. In this way, regulatory services would be financed based directly on value provided, in contrast to an information revenue cross-subsidy. Indeed, through its relationship with the International Securities Exchange, L.L.C., NASDR has illustrated that regulatory services have considerable economic value.

Importantly, sponsorship need not mean technology provision. To the contrary, the Exclusive SIP would provide means of access to the sponsored non-SRO participant directly, unless the non-SRO chose to receive information and access via the SRO sponsor. The SRO sponsor would, of course, reserve the right to instruct the Exclusive SIP to discontinue the sponsored entity's access in the case of violations of NMS rules or at termination of the sponsorship relationship.

Finally, consistent with the SEC Order Handling Rules and Regulation ATS, any market maker or ATS that is not a sponsored participant in the Exclusive SIP must represent all eligible interest via an SRO, which will then reflect orders in the NMS.

[18] As described earlier, this is currently the case in the OTC marketplace. Supra note 7.

D. NMS Technology

The IT Provider would be required to meet minimum standards to be selected as the official provider:

1. The IT Provider would be required to have systems capacity and architecture to receive full depth of book from all participating market centers. Although market centers would not be required to reflect such information, market centers should have the option to reflect additional information. Indeed, full depth of book has become de rigueur for the past four years; creating an Exclusive SIP without the ability to collect complete information would represent a "giant leap backward."

2. The IT Provider would be required to attribute each participant quotation, irrespective of sponsorship (i.e., a sponsored entity receives attribution). Quotation attribution is crucial for several reasons. First, liquidity providers derive perceived value from a public advertisement of wares, which can lead to additional order flow. Second, attribution enables competing linkages to develop. If quotations were not attributed to market centers, no market participant would know who is reflecting the best price and, therefore, could only access the reflected order through the Exclusive SIP.[19] Third, quotation attribution enables competing Information Collectors to assign different economic values to information from different participants based on the quality of each participant's quotations.

3. The linkage system would be based on a highly-automated order delivery framework, as opposed to an execution delivery scheme. Without an order delivery system, agency markets cannot participate due to dual liability risk.[20] In addition, automatic execution may not be a part of the business model for every market participant. For instance, the NYSE often delays order execution for reasons of "price improvement." Plainly, execution delivery would not accommodate this approach. The order delivery design of the current NMS linkage systems—NASDAQ's SelectNet System for the OTC marketplace and ITS for Exchange-listed securities—is the most robust

[19] Indeed, robust quote competition has been a clearly stated goal of the SEC and many market participants for a number of years. See, e.g., Arthur Levitt, "Toward Markets Driven By Footsteps," Speech at Securities Traders Association, October 12, 2000 available at http://www.sec.gov/news/speeches/spch407.htm.

[20] See Letter from Gerald Putnam, Chief Executive Office, Archipelago, to Jonathan Katz, Secretary, SEC, dated June 14, 1999 (available at http://www.tradearca.com/news_and_views/viewpoints/viewpoint_061499.pdf) and, Letter from Gerald Putnam, Chief Executive Office, Archipelago, to Jonathan Katz, Secretary, SEC, dated October 25, 2000 (available at http://www.tradearca.com/news_and_views/viewpoints/viewpoin2_102500.pdf) (describing deficiencies associated with an execution-delivery scheme, viz. the creation of a massive single point of failure).

approach from the perspective of aiding and abetting varied, competing approaches to order handling and execution.[21]

4. The IT Provider would be required to disseminate all information to all market data subscribers at an equivalent speed and cost. Because the Exclusive SIP would be deemed an SRO-operated public utility, it would have to treat all market participants equally. Accordingly, all investors and market professionals would have equivalent access to the utility's information.

5. Although not a prerequisite, the IT Provider should utilize an industry-standard format (e.g., FIX). Non-standard formats are costly for a large number of participants to develop and maintain. A standard format would enable the IT Provider to change without causing all market centers to re-structure their network linkage.

6. The IT Provider should implement an Internet-type, non-centralized network architecture rather than a "hub-and-spoke" scheme, which inevitably leads to single point of failure exposure.

[21] Despite other substantial flaws, execution delivery systems do provide expeditious disposition of trading interest. Specifically, execution delivery enables market participants to obtain immediate notification about whether orders are executed. To this end, the NMS Governing Committee could set standards for response times, perhaps similar to those required of ECNs that participate in the OTC marketplace.

IV. ANALYSIS OF EFFECTS OF PROPOSED IMPROVEMENTS

The Archipelago Proposal would provide for equivalent services that exist in the NMS today. Moreover, the Proposal improves three areas in which the current NMS structures are sorely deficient: facilitation of market center competition; rationalization of market information services; and, improvement of intermarket accessibility.

A. Facilitation of Market Center Competition

Under the Proposal, new initiatives by the Governance Committee would not be subject to unanimity provisions, which have been employed in the past to veto innovation both within and without NMS plans. Under the Proposal, no single market participant could prevent other market centers from implementing new business initiatives. [22]

To participate directly in any of today's national market systems, a market center must be an SRO; ATSs and broker-dealers are precluded from directly participating. Under the Archipelago Proposal, non-SRO market centers could directly participate without registration as an SRO. Non-SRO market centers could contract with an existing SRO for regulatory sponsorship. In this way, new, innovative market participants could quickly integrate into the NMS on fair and equitable terms.

B. Rationalization of Market Information Services

An oft-voiced complaint about U.S. markets today is that information revenues are "too high" or "uncompetitive." The problem is that the value of information is not determined by market mechanisms. Indeed, market participants differ substantially on the value of this information. Some participants, such as the Island ECN, Inc., provide it free of charge over the Internet; others, such as the American Stock Exchange, Inc., sell information at the rate of a few dollars a trade—an amount comparable to a commission rate at a deep discount brokerage.

Today, information revenue is essentially subject to a Commission-sponsored rate-setting exercise via the NMS plans, which are infrequently modified. Given that market information is the "lifeblood of our markets," such a model is untenable; we cannot continue to trust such a valuable service to an industry-sponsored utility. [23] Moreover, the current constraints regarding the type of information a Information Collector may collect and distribute serve to limit the quality of information provided to

[22] It appears that the Antitrust Division of the Department of Justice could view the extant NMS plans, or activities associated therewith, as serious constraints to intermarket competition. See, e.g., United States v. American Stock Exchange, et. al., No. 1:00CV02174 (D.D.C. filed September 11, 2000), Complaint at 10.

[23] "Quality Information: The Lifeblood of Our Markets," Chairman Arthur Levitt, The Economic Club of New York, October 18, 1999.

investors. Ironically, in the name of NMS plan rules, a number of attempts have been levied at innovators to limit information display over recent months. [24]

By allowing competing Information Collectors to include additional data and collect and sell data to vendors, the Proposal would replace an infrequent rate-setting exercise with market forces for a valuable service. In this way, the market would reward those that provide value; costly cross-subsidies of inefficient providers would no longer pose an implicit tax to investors.

In addition to rationalizing the pricing of information, the Proposal would further rationalize its provision in terms of technology. For far too long, market participants have labored under inefficient Exclusive SIPs that were capacity strained, or could not complete rudimentary tasks such as decimalization. As with rate-setting, such industry-wide inefficiencies are, in effect, implicit taxes on the level of service provided to investors. It is high time to rationalize information provision so that the NMS aspects of securities trading do not unduly constrain the industry.

C. Improvement of Intermarket Accessibility

Currently, NMS structures that address intermarket accessibility—such as ITS and OTC-UTP—are, by their own admission, based on anachronistic technology. Further, participants regard the regulatory apparatus that police intermarket interactions as less than effective at resolving disputes.

By providing a more active, formal regulatory mandate for NMS plans, the Proposal would assure participants that intermarket interactions would be fair. Furthermore, by contracting with a expert technology provider, and by relying on industry-standard message protocols, the Proposal would vastly simplify, and render cost effective, the means of linkage to an Exclusive SIP. These developments would mark a substantial improvement over today's intermarket accessibility.

[24] At the most recent meeting of the ITS Operating Committee in October, 2000, one ITS participant stated that an exchange that publishes its book outside of the NMS would violate SEC Rule 11Ac1-2, the Vendor Display Rule, and, therefore, violate the NMS Plan.

V. IMPLEMENTATION OF UPDATED NMS: OTC SECURITIES

As discussed above, NASDAQ evolved as an intermarket linkage system due to the SEC's requirement that the NASD develop an electronic marketplace for broker-dealers trading OTC securities. [25] Until 1988, no Exchange expressed an interest in trading OTC securities, which meant that there was no NMS framework in which non-NASD SROs could participate. In 1988, the NASD and the Chicago Stock Exchange, Inc. ("CHX") negotiated a "temporary" participation plan. In 1990, the temporary plan was replaced by today's OTC-UTP, which has existed since that time on a pilot basis. [26] Under OTC-UTP, NASDAQ was designated as the Exclusive SIP for OTC securities.

Because OTC-UTP does not clearly delineate the intermarket functions served by NASDAQ as Exclusive SIP, and the "intra-market" functions served by NASDAQ as operator of a network that organizes OTC quotations of dealers and ECNs, the plan presents competitive difficulties to would-be SRO entrants. Indeed, rather than use the technology contemplated by OTC-UTP, CHX determined to use the existing NASDAQ architecture and participate in NASDAQ in a manner roughly similar to market makers and ECNs. In other words, as a practical matter, OTC-UTP does not provide a feasible linkage system for competing Exchanges; instead, the NASD has co-mingled NASDAQ's delegated function as Exclusive SIP with its SIP-like role for ECNs and OTC dealers.

As a result, when a new OTC-UTP Exchange entrant begins trading today, it must negotiate the terms and conditions of participation with NASDAQ. In the past, this has not presented extreme conflicts of interest because NASDAQ did not operate an execution facility. As NASDAQ moves towards its Super Montage proposal and exchange registration, however, it will increasingly compete with Exchanges and its membership. As such, requiring would-be OTC-UTP entrants to negotiate terms of participation with NASDAQ—a competitor—is unworkable because of clear, substantial conflicts. Nowhere is the potential for abuse so rampant; in what other industry is each new entrant required to agree to participation standards set by its largest competitor?

In addition, OTC-UTP participants are subject to revenue sharing caps. Specifically, a market center cannot earn additional market data revenue once it has exceeded the volume level associated with certain pre-determined revenue sharing caps. Instead, the NASD—an affiliate of NASDAQ, competitor to all participant Exchanges—retains all associated market data revenue above the capped levels. These caps apply for the first 4 ½ years of participation in OTC-UTP.

To remedy these problems, the Archipelago Proposal would eliminate the current barriers to entry and would establish a framework by which one competitor cannot unreasonably limit another's growth. (Figure 2 illustrates the OTC NMS, as reconstituted under the Proposal.)

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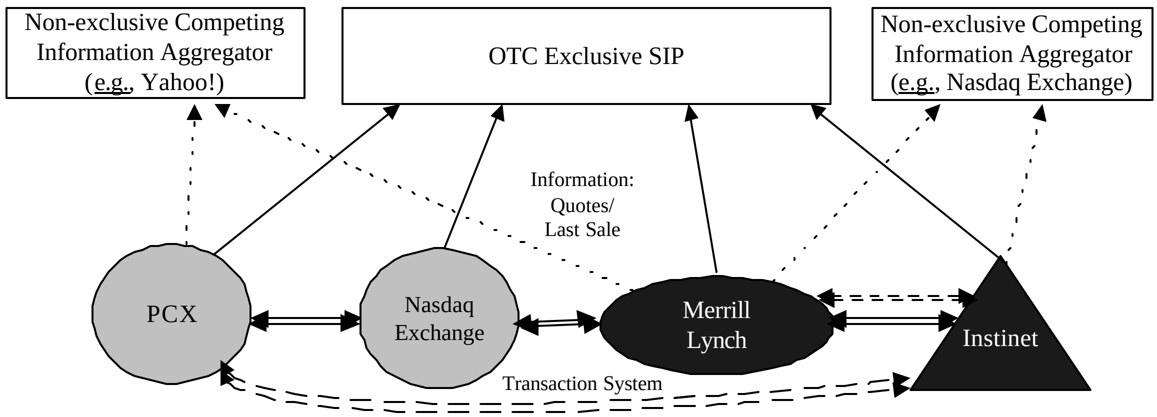
[25] See note 2, supra.

[26] Although OTC-UTP is a pilot program, it has not materially changed since inception.

Figure 2: Proposed National Market System, OTC Securities



The Governing Committee would be composed of current OTC-UTP participants.[27] The Governing Committee would solicit bids to replace NASDAQ—a conflicted entity—as the IT Provider. (Although NASDAQ could bid for the role, its role shall not be assumed.) The Governing Committee would appoint an IT Provider based on the relative merits of the proposals it reviews.

All OTC-UTP marketplace rules would be determined by a majority vote of the Governing Committee. For instance, the Governing Committee would need to agree to a revenue sharing plan, the handling of market access fees, and response time standards, if any. Moreover, the Governing Committee would adopt all pertinent SEC rules.

All OTC-UTP participants would submit top of book and last-sale information to the OTC Exclusive SIP. The participants could also submit information to any other venue. For instance, the PCX could submit its OTC top of book and last-sale information to two different venues: the OTC Exclusive SIP and a Information Collector, such as Yahoo!.

In addition, ECNs, other ATSs, and broker-dealers could submit information directly to the OTC Exclusive SIP. In order to do so, however, these participants would have to be sponsored by an OTC-UTP participant SRO, such as the NASD or CHX. This SRO would be responsible for ensuring that the sponsored entity comply with all OTC-UTP marketplace rules.

Under this framework, new market participants could easily enter the NMS for OTC securities. First, market centers would not need to register as an SRO because they could be sponsored by an existing SRO. Second, all market participants would

[27] The current OTC-UTP Plan consists of five members: the NASD; CHX; the American Stock Exchange, Inc.; the Cincinnati Stock Exchange, Inc.; and the Pacific Stock Exchange, Inc. In addition, the Boston Stock Exchange, Inc. is a "Limited Participant," meaning Boston must submit information but does have voting authority.

collectively determine participation rules, in contrast to today's conflicted world of bilateral, *ad hoc* negotiations with a near-monopolist competitor. Third, a revenue sharing algorithm would be determined by all market participants rather than by a single participant based on its own business predilections.

Further, because competing market data providers could develop, the OTC Exclusive SIP's market data fees would become competitively determined. Specifically, if data provided by the OTC Exclusive SIP were priced beyond its economic value, competing Information Collectors would step in and provide the data for a lower rate. As more Information Collector entrants participate, reliance on the Exclusive SIP for consolidation services is reduced—and eventually the Exclusive SIP could be discontinued in lieu of a fully-competitive model.

Archipelago has described OTC-UTP as a "case study" because of both the size of the associated conflicts and the alacrity with which NASDAQ is moving to establish itself as a competitive execution venue via its Super Montage proposal and application to become an Exchange. [28]

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[28] At the risk of implying that the NMS for NYSE-listed securities is in any way a paradigm of co-operation and efficacy, the conflicts inherent with OTC-UTP would be comparable to those for NYSE securities if: (1) the NYSE purchased the remaining 33% interest in the Securities Industry Automation Corporation ("SIAC") Exclusive SIP for NYSE-listed securities; (2) SIAC announced that all Exclusive SIP related technologies would be integrated with those of the NYSE, e.g., SuperDOT would replace ITS; (3) CTA/CQS revised revenue sharing schemes to cap all participants at 2.2%, with the balance accruing to the NYSE's account; and, (4) ITS Operating Committee determined to cancel all regular meetings indefinitely, including those at which regulatory business is conducted.

VI. CONCLUSION: WE PROPOSE TO MOVE FASTER

Despite profound change in terms of both technology and marketplace innovations, the bedrock principles upon which Congress based the concept of the National Market System a quarter-century ago—information consolidation, access to the best available price, and reliance on competitive forces—are as applicable today as they were then, The structures relating to the implementation of the NMS, however, have not stood the test of time nearly as well. Indeed, today these NMS structures pose barriers to innovation and constrain the cost of securities trading through use of now-ancient technology and a rate-setting apparatus for the sale of market-related information (such as trades and quotes).

The Archipelago Proposal would remove these impediments by injecting a salutary dose of market-based competition into the NMS—by allowing new entrants to build businesses around the collection and sale of market data and around the provision of technology services for the NMS. In so doing, the Proposal would also extirpate the pernicious conflicts of interest that plague NMS plans in which the Exclusive SIP is also a participant.

Only by truly opening the NMS structure to innovators—be they information consolidators, new trading venues, or organizations that recognize the economic value of effective regulation—can we serve investors to the fullest extent possible.

There are many who would wield NMS structures in support of parochial interests, or would slow down the process as a shield from market forces. To those that would proceed in such a fashion, Archipelago "proposes to move faster."