

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-63745; File No. SR-NASDAQ-2011-010)

January 20, 2011

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Link Market Data Fees and Transaction Execution Fees

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on January 10, 2011, The NASDAQ Stock Market LLC (“NASDAQ” or the “Exchange”) filed with the Securities and Exchange Commission (the “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NASDAQ proposes to reduce market data fees and transaction execution fees for retail investors. NASDAQ, like the Commission, “is particularly focused on the interests of long-term investors.”<sup>3</sup> Retail investors’ orders are often executed away from well-regulated public exchanges that offer pre-trade transparency. The Commission has noted that absent extraordinary conditions such as those occurring on May 6, 2010, retail orders are generally executed by internalizers away from exchanges and without pre-trade transparency, exposure or order interaction.<sup>4</sup> In NASDAQ’s

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Exchange Act Release 61358, Concept Release on Equity Market Structure (Jan. 14, 2010), at p. 33.

<sup>4</sup> See Findings Regarding The Market Events Of May 6, 2010, Report Of The Staffs Of The CFTC And SEC To The Joint Advisory Committee On Emerging Regulatory Issues, September 30, 2010, at p. 56. It is often contended that dark markets serve the interests of large investors whose order sizes give rise to the potential for adverse market movements. Such potential does not exist in the case of smaller retail orders.

view, the likelihood that retail investors' orders are executed away from exchanges is impacted by disparities in regulation between lit markets such as those operated by exchanges<sup>5</sup> on one hand and broker systems or dark markets operated as Alternative Trading Systems on the other. One such disparity provides dark markets great flexibility to price differentiate between subscribers, while denying exchanges the same flexibility to differentiate between members. Furthermore, although exchanges and dark markets compete for the same order flow and for the same transactions, exchanges must file proposed fee schedules and changes, while other markets have no such burden. The result is that proposed rule changes that impact NASDAQ's ability to compete for order flow, transactions, and market data, such as the current proposal, are subject to significant scrutiny and potential delay while similar conduct by other markets is subject to no public filing requirement, no regulatory delay, and for dark markets is opaque to investors and competitors alike.

This filing is an attempt by NASDAQ to compete to attract retail investors' orders and to improve the experience of retail investors on NASDAQ's public market. NASDAQ is reducing fees for members that serve retail investors. Specifically, NASDAQ is reducing the costs of executing trades and of providing "depth of book" data products for NASDAQ member firms that service "non-professional" users with which the firm has a brokerage relationship. The more NASDAQ data a firm provides to retail investors, and the more that firm trades on NASDAQ, the lower its fees will be. This is an optional pricing proposal designed to benefit non-professional investors by providing an incentive for them to trade in the well-regulated, publicly-displayed market that NASDAQ operates.

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<sup>5</sup> Alternative Trading Systems that meet the five percent display threshold under Regulation ATS also qualify as lit markets with higher regulatory requirements. NASDAQ is not aware that any ATS is operating under these conditions today.

NASDAQ will implement the proposed change on January 3, 2011. The text of the proposed rule change is available at <http://nasdaq.cchwallstreet.com/>, at NASDAQ's principal office, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASDAQ included statements concerning the purpose of, and basis for, the proposed rule change. The text of these statements may be examined at the places specified in Item III below, and is set forth in Sections A, B, and C below. NASDAQ has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rule Change

1. Purpose

This filing reduces prices for NASDAQ market data and for trading on NASDAQ. The proposed price reduction is targeted at retaining the business of members that represent retail investors and that redistribute market data to them in a non-professional capacity. NASDAQ believes that this proposal thereby promotes NASDAQ's and the Commission's goal of better serving long-term, retail investors and restoring confidence in public capital markets. The participation of these investors in NASDAQ's market benefits NASDAQ, its listed companies, its market quality, and the quality of its data products. The proposal is also a competitive response to other trading venues that have used price discounts to entice firms to shift order flow and data consumption, and that may continue to do so in the future. In short, NASDAQ is attempting to compete on price for the business of customers that are highly valued to NASDAQ and important to the health of U.S. capital markets.

## Description of the Pricing Proposal

NASDAQ is proposing a discount for its depth-of-book data products and an enhanced liquidity provider rebate based upon the extent to which a NASDAQ member both consumes NASDAQ market data and also contributes to the quality of NASDAQ data through liquidity provision. This program focuses on non-professional use of “NASDAQ Depth Data Product Fees” which are the non-professional fees for NQDS (Rule 7017), and TotalView and OpenView (Rule 7023), including fees for usage (Rule 7026) and enterprise license fees. It also focuses on average daily liquidity provision to the NASDAQ Market Center as that activity is measured today in NASDAQ Rule 7018. This pricing is completely optional; no member is required to participate or excluded from participating.

The market data discount provided through the proposal is for fees incurred by NASDAQ members in providing NASDAQ depth-of-book data to non-professional users. A member incurs non-professional fees when it offers depth-of-book data to natural persons that are not acting in a capacity that subjects them to financial industry regulation (*e.g.*, retail customers).<sup>6</sup> NASDAQ seeks to encourage wide distribution of market data to non-professional users, because it believes that this will encourage more order flow from investors whose trading volumes are elastic and therefore influenced by factors such as the availability of data.

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<sup>6</sup> NASDAQ Rule 7017(c) defines a non-professional as a natural person who is neither:

- (1) registered or qualified in any capacity with the Commission, the Commodities Futures Trading Commission, any state securities agency, any securities exchange or association, or any commodities or futures contract market or association;
- (2) engaged as an "investment adviser" as that term defined in Section 201(11) of the Investment Advisors Act of 1940 (whether or not registered or qualified under that Act); nor
- (3) employed by a bank or other organization exempt from registration under federal or state securities laws to perform functions that would require registration or qualification if such functions were performed for an organization not so exempt.

NASDAQ also expects that some of the benefit of the fee reductions offered through the proposal will be passed on to brokerage customers. For this reason, NASDAQ already provides a discounted rate for non-professional data, whether it is sold directly to a non-professional user or distributed to the user through a broker. NASDAQ believes that non-professional users that are able to make use of depth data also have a degree of knowledge about market structure that would cause them to favor limit orders, rather than market orders, when buying and selling. Thus, through the proposal, NASDAQ hopes to encourage a “virtuous circle” in which firms route more liquidity-providing orders to NASDAQ and consume and distribute more data in order to receive the discount, with increased data distribution in turn encouraging still more liquidity provision. NASDAQ also hopes to encourage additional firms to provide depth-of-book to their customers.

The program has three tiers, each with two requirements, one based on liquidity provision and the other based on data consumption. A member will qualify as a “Tier 1 Firm” for purposes of the discount during a particular month if it (i) has an average daily volume of 12 million or more shares of liquidity provided through the NASDAQ Market Center in all securities during the month; and (ii) incurs NASDAQ Depth Data Product Fees (as defined above) during the month of \$150,000 or more (prior to applying the discount provided by this proposal). A member will qualify as a “Tier 2 Firm” for purposes of the discount during a particular month if it (i) has an average daily volume of 35 million or more shares of liquidity provided through the NASDAQ Market Center in all securities during the month; and (ii) incurs NASDAQ Depth Data Product Fees during the month of \$300,000 or more (prior to applying the discount provided by this proposal). A member will qualify as a “Tier 3 Firm” for purposes of the discount during a particular month if it (i) has an average daily volume of 65 million or more

shares of liquidity provided through the NASDAQ Market Center in all securities during the month; and (ii) incurs NASDAQ Depth Data Product Fees during the month of \$500,000 or more (prior to applying the discount provided by this proposal).

Firms that qualify as Tier 1, Tier 2, or Tier 3 Firms will receive discounted market NASDAQ Depth Data Product Fees and, in the case of Tier 1 Firms, increased liquidity provider credits. With respect to market data fees, Tier 1 Firms will receive a 15% discount on non-professional fees for NASDAQ Depth Data Products charged to them. Tier 2 Firms will receive a 35% discount on non-professional fees for NASDAQ Depth Data Products charged to them. Tier 3 Firms will receive a 50% discount on non-professional fees charged to them.<sup>7</sup> The discounted NASDAQ Depth Data Product Fees are tailored to benefit firms that provide a high quantity of data to non-professional retail investors and that also contribute significantly to the quality of NASDAQ data.

With respect to liquidity provider credits, Tier 1 Firms will qualify for a credit of \$0.0028 per share of displayed liquidity provided and a \$0.0015 per share of non-displayed liquidity. These rates are higher than the \$0.0020 and \$0.0010 per share of displayed and non-displayed liquidity provider credit available to firms that provide the same 12 million shares of liquidity per day without also consuming NASDAQ Depth Data Products sufficient to qualify for Tier 1 as defined here.<sup>8</sup> These credits are not incrementally higher than the credit currently available to firms providing 35 and 65 million shares of liquidity daily. In other words, the benefit available

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<sup>7</sup> Since the eligibility of a member for the discount is determined on a month-by-month basis, data fees that are paid on an annual basis, such as the annual administrative fee for market data distributors under Rule 7019(a), are not covered by the definition of NASDAQ Depth Data Product Fees, and are therefore not counted in determining a firm's status as a Tier 1, Tier 2 or Tier 3 Firm.

<sup>8</sup> Tier 2 and Tier 3 Firms will receive the current liquidity provider credit of \$0.00295 per share of displayed liquidity and \$0.00015 per share of non-displayed liquidity. There is no enhancement to these liquidity provider credits at this time.

to Tier 2 and Tier 3 Firms under this program is limited to the discount for NASDAQ Depth Data Products described above.

The proposal is designed to recognize the benefits to NASDAQ, its listed companies, its market quality, and the quality of its proprietary data products that are provided by member firms that both post retail liquidity on NASDAQ and redistribute data to their customers. The proposal is also a direct competitive response to other trading venues that have used price discounts to entice firms to shift order flow and data consumption, and that may continue to do so in the future. Firms that are eligible for the discount are key contributors to market quality, by providing liquidity to support rapid execution of incoming orders with minimal price impact. These firms are able to shift their business immediately to competing exchanges, which requires NASDAQ to offer competitive responses to keep the business of these valued customers. NASDAQ currently recognizes the value of liquidity provision by offering liquidity provider credits that rise with the volume of liquidity provided. For companies listed on NASDAQ, liquidity provision dampens volatility by allowing higher volumes to trade at a consistent price.

#### Single Platform, Joint Products

NASDAQ is offering a joint discount on market information and executions because, as described in greater detail in the attached Statement of Ordovery and Bamberger (Exhibit 3), The NASDAQ Market Center is a single trading platform that unavoidably produces joint products: execution services and market data. Every execution of a trade automatically produces market information about that trade including the price and quantity traded. Every execution requires posted and taking orders, which in turn produce market data in the form of quotations, including top-of-book and depth-of-book quotations. Market information and executions are inextricably linked; each is both an input and a byproduct of the other and neither can exist without the other.

The operation of The NASDAQ Market Center and the production of joint products (executions and market information) require NASDAQ to incur joint costs. NASDAQ's costs to produce market information and executions are inseparable in that most of them are not uniquely incurred on behalf of either of the services provided by the exchange. To operate its trading platform, NASDAQ must incur high fixed costs before accepting a single order, executing a single trade, or producing a single element of market information. Each year, NASDAQ spends millions of dollars on market infrastructure such as servers, processors, line handlers, software, and personnel; data intake, processing and dissemination equipment and networking hardware and software; and regulatory and surveillance systems of both a manual and automated nature. NASDAQ incurs these high costs to operate the platform and to produce both executions and market information. In other words, without these costs, neither product is produced, but with them, both products are unavoidably produced.<sup>9</sup>

NASDAQ recaptures the cost of operating its platform through the sale of both executions and market information. The total return that NASDAQ or any trading platform earns reflects the revenues it receives from the sale of these joint products and other services, net of the joint and other costs (i.e., those limited costs that can be directly attributed to one of the relevant products) it incurs. Different platforms choose different pricing strategies and ways of recovering total costs. NASDAQ pays rebates to attract orders, charges relatively low prices for market information and charges relatively high prices for accessing posted liquidity. Other platforms may choose a strategy of paying lower liquidity rebates to attract orders, setting relatively low prices for accessing posted liquidity, and setting relatively high prices for market

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<sup>9</sup> This point was recognized over a century ago by the British economist Alfred Marshall, who noted the inextricability of producing wool and mutton and the inextricable nature of the costs associated with such production.

information. Still others may provide most data free of charge and rely exclusively on transaction fees to recover their costs. Finally, some platforms may incentivize use by providing opportunities for equity ownership, which may allow them to charge lower direct fees for executions and data.<sup>10</sup> These strategies can vary over time in response to changing market and regulatory factors.<sup>11</sup>

The Commission has acknowledged many times that trading platforms compete fiercely for executions. Platforms also compete for the sale of market data. For example, in June 2008, NASDAQ launched two proprietary “Last Sale” products. In each case, the terms included subscription rates and an “enterprise cap” rate designed for Web portals. The enterprise cap rates for the two products were \$100,000 per month and \$50,000 per month for the two products (i.e., a total of \$150,000 per month for customers who purchased both products). The majority of NASDAQ’s sales were at the cap level. In early 2009, we understand that BATS offered an alternative product (BATS PITCH data) as a zero-cost alternative to the NASDAQ Last Sale

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<sup>10</sup> See, e.g., Securities Exchange Act Release No. 62358 (June 22, 2010), 75 FR 37861 (June 30, 2010) (SR-NSX-2010-06). It has also been reported that NYSE Amex has offered equity incentives to active members. While Nasdaq is aware of no Amex rule filing with the Commission, Amex consistently refers publicly to the “semi-mutualization.” program. See, e.g., NYSE Euronext Brings Partners Into Options Market (Dow Jones Newswires, September 9, 2009); Comments of Duncan Neiderauer at NYSE Euronext Q3 2009 Earnings Call (October 30, 2009).

<sup>11</sup> Similarly, Marshall’s sheep farmer would be expected to cover his costs of production through the sale of both wool and mutton, and it would be unreasonable for sweater-wearers to demand free sweaters subsidized by consumers of mutton. Moreover, in contrast to sheep farming, consumption of each of NASDAQ’s main products enables further production and consumption of the other – more executions translate into more data, and more data usage encourages more executions. Accordingly, as discussed below, there is no basis in the Act for requiring these inextricably linked products to be priced in isolation from one another. Such a result makes no more economic sense than requiring the price of a live sheep to be divorced from the price of wool and mutton.

products.<sup>12</sup> Also in early 2009, NYSE Arca announced the launch of a competitive product with an enterprise price of \$30,000 per month. In response, NASDAQ combined its two Last Sale products into one in April 2009, and reduced the enterprise cap to \$50,000 per month (i.e., a reduction of \$100,000 per month).

Given the joint nature of these products and the competitive markets in which they are offered, a bundled discount that is linked to total spending across the joint products is economically sensible for a single platform producing joint products. Bundling recognizes the value of liquidity provision and data distribution in creating the conditions that further encourage the creation of the trading platform's products. It also recognizes the fact that customers are differentiated on multiple dimensions in terms of their willingness to pay for data and for accessing liquidity. Platform pricing of market data and executions enables NASDAQ to design a plan that will appeal to a broader group of potential customers – in this case those serving retail investors – and stimulate overall sales of both data and trading. NASDAQ expects that bundling will be more appealing to its customers than offering discounts based only on the volume of one kind of activity or another, as it has done in the past. By conditioning the discount on two activities, NASDAQ can achieve improved participation from both retail brokers that distribute data and their order-providing customers, as compared to a disaggregated pricing approach.<sup>13</sup>

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<sup>12</sup> Subsequently, BATS has begun to charge for certain of its data products, signaling a shift in strategy to recover a greater percentage of its costs through data, rather than using data solely as a means to draw (fee-liable) orders to its market.

<sup>13</sup> Bundled pricing is also evident – indeed, it arguably finds its most complete expression – in exchange programs to offer equity ownership to favored members. Equity allows its owner to participate in the upside of all aspects of an exchange's operations, including executions, data, and listings. Thus, equity shares offered in exchange for liquidity provision offset the costs of all exchange products that the favored member consumes, effectively translating into an across-the-board discount and encouraging further consumption that enhances the value of the equity. Moreover, participation in such programs is conditioned upon being a member that directs order flow to the exchange in

Given the fierce competition between platforms, as evidenced by rapid shifts in order flow and price cutting behavior in markets for data, the competitive concerns potentially implicated by bundling are not present here. Competitive concerns from a practice of bundling discounts across a range of products may potentially arise when such bundling is used to foreclose entry (expansion) of rival firms that may not be able to offer an array of products as broad as that offered by an incumbent. In the instant case it is not likely that the combined offer will induce rival exchanges to exit (or become less competitively potent due to a reduction in volume), since many of NASDAQ's competitors command a comparably strong measure of market share in the relevant markets. Accordingly, their product offerings can readily compete with NASDAQ's in terms of execution functionality, depth of data, and price (included, if they deem it appropriate, bundled prices). It is also not likely that the combined offer will have the effect of creating significant barriers to entry or expansion for new exchanges. Current conditions of market fragmentation underscore the absence of barriers to entry in the market to attract and execute order flow. Because executions necessarily create data, barriers to entry in that market are correspondingly low.<sup>14</sup>

#### Price Differentiation Is Consistent with the Exchange Act

For many years, exchanges have engaged in and the Commission has accepted the practice of price differentiation, both in the context of market data as well as in the context of executions. With respect to market data, NASDAQ and NYSE in their capacities as network

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question, thereby excluding non-members, such as non-broker data distributors, as well as members that choose to direct order flow elsewhere. Moreover, an equity distribution program cannot be open-ended without diluting its value to the first recipients. Accordingly, once the equity distribution program is closed, incumbent owners benefit on an ongoing basis and new members are frozen out.

<sup>14</sup> A further discussion of competitive conditions in the market for exchange data is provided in NASDAQ's "Statement on Burden on Competition" below.

processors and exchanges have differentiated in pricing between professional and non-professional market data users often charging professionals many times more than non-professionals for using the same data. For example, consolidated data for NASDAQ stocks costs non-professional investors just one dollar per month, whereas professional investors pay twenty dollars per month for the same data. Also, NASDAQ currently charges \$15 per terminal for its TotalView product to non-professionals, while professional investors pay roughly five times the non-professional rate. This reflects the value of the service to various constituencies (i.e., lower prices are charged to consumers with more elastic demand) and allows both types of investors to contribute to the high fixed costs of operating an exchange platform.<sup>15</sup> Thus, one of the two bases for differentiation employed here – reduced prices for non-professional data usage – is completely consistent with economic theory and past Commission precedent.

Similarly, the Commission has long accepted price differentiation between and among members of trading platforms that provide and take liquidity to execute trades. For example, exchanges have offered and continue to offer differential pricing based on absolute volume, incremental volume, order type, ticker symbol, routing strategy, stock price, equity ownership,<sup>16</sup> and other characteristics. Other platforms, including electronic communications networks and other forms of alternative trading systems (“ATs”), including dark pools, differentiate on these

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<sup>15</sup> As discussed in Exhibit 3, charging lower fees to non-professional consumers increases overall economic welfare by increasing output – in this case, providing more data to more investors – and avoids two equally undesirable alternatives: (i) requiring the firm to charge uniformly high prices that constrict demand, or (ii) insisting on uniformly low prices at marginal cost (in this case, zero or close to zero) that do not allow the firm to cover its fixed costs and thereby lead to bankruptcy.

<sup>16</sup> An equity ownership program in which a member receives equity in exchange for its initial order flow commitment gives rise to differential pricing in which two classes of participants that thereafter engage in the same behavior are treated differently on an ongoing basis: the equity owner is rewarded for participation through the increased value of its stock, and the non-owner is not.

dimensions and, NASDAQ understands, other dimensions that exchanges are prohibited from using.<sup>17</sup> The differentiation that NASDAQ's proposes here – higher rebates for larger liquidity providers – is entirely consistent with past precedent and with the Act as interpreted and applied by the Commission.

Thus, the Commission has accepted in individual form the precise elements of the price differentiation that NASDAQ is proposing here in joint form. As explained above and in Exhibit 3, this is especially appropriate where the products subject to the joint pricing – market data and executions – are themselves joint products of a single platform: joint pricing will allow exchanges to structure fees that recognize the contribution of particular classes of members to the creation of the products and thereby broaden output and reduce fees

The Commission should also recognize that trading platform operations are characterized by high fixed costs and low marginal costs. This cost structure is common in content and content distribution industries such as software, where developing new software typically requires a large initial investment (and continuing large investments to “upgrade” the software), but once the software is developed, the incremental cost of providing that software to an additional user is typically small, or even zero (e.g., if the software can be downloaded over the internet after being purchased).<sup>18</sup> In NASDAQ's case, it is costly to build and maintain a trading platform, but the incremental cost of trading each additional share on an existing platform, or distributing an additional instance of data, is very low. Market information and executions are each produced

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<sup>17</sup> For example, we understand that ATSS routinely negotiate individualized pricing packages with their subscribers, and deny access to disfavored users.

<sup>18</sup> See William J. Baumol and Daniel G. Swanson, “The New Economy and Ubiquitous Competitive Price Discrimination: Identifying Defensible Criteria of Market Power,” Antitrust Law Journal, Vol. 70, No. 3, 2003.

jointly (in the sense that the activities of trading and placing orders are the source of information that is distributed) and are each subject to significant scale economies.<sup>19</sup>

That NASDAQ's platform produces market information and executions jointly and in scale does not mean that either of the joint products should be, or even can be, offered at no charge or at marginal cost. Marginal cost pricing is not feasible when there are increasing returns to scale because if all sales were priced at marginal cost, NASDAQ would be unable to defray its platform costs of providing the joint products. Moreover, to offer market data at no cost would require NASDAQ to raise the cost of providing execution services because it would require execution services to cover 100 percent of the recovery of the joint and common costs of both execution services and market data. While this may be a viable choice for some platforms, individual platform operators can and do reasonably choose other pricing models to allocate the recovery of cost between the joint products. At the same time, as discussed below and in Exhibit 3, competition between platforms clearly constrains the ability of platform operators to price execution services and market data products.

The Commission has previously stated, in dicta, that “the Exchange Act precludes exchanges from adopting terms for data distribution that unfairly discriminate by favoring participants in an exchange's market or penalizing participants in other markets.”<sup>20</sup> The Commission provided no analysis in support of this statement. NASDAQ believes that consideration of the joint nature of the products in question and the Commission's precedents will allow a more developed analysis of conduct that constitutes unfair discrimination under the

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<sup>19</sup> This is not the case with Marshall's sheep farming. Sheep are likely produced with constant or increasing marginal cost, and the pricing complication is confined to the most efficient recovery of the marginal cost of a sheep.

<sup>20</sup> Securities Exchange Act Release No. 59039 (December 2, 2008), 73 FR 74770 (December 9, 2008) (SR-NYSEArca-2006-21), vacated by NetCoalition v. SEC, No. 09-1042 (DC Cir. 2010).

Act. As noted above, the Commission has allowed exchanges to price discriminate in a wide range of respects, including, for example, volume-based execution discounts that directly favor participants in the exchange's market, discounts on uses of particular order types or strategies that favor participants with certain trading models, and selective equity ownership that provides effective discounts on all of the exchange's products, including data, and that discriminates in favor of active participants in the exchange's market during a set offering period. Moreover, in light of the joint nature of an exchange's transaction and data products, uniform fees – requiring exchanges to charge the same fees to data consumers that help to produce data as it charges to those who do not – could be said to discriminate against participants by requiring them to pay fees that are not allocated based on the value of their participation in the market. Thus, if it is fair to discount execution fees to liquidity providers because they add value to the market place, it should also be considered fair to discount data fees to liquidity providers because they add value to data.

In addition, it is difficult to discern a reasonable policy goal behind a strict prohibition on data discounts that consider transaction activity. As noted above and in Exhibit 3, differences in pricing may increase economic welfare by allowing greater distribution than would otherwise be the case, and also, in this case, enhance the value of NASDAQ's joint product to the extent that greater consumption of data encourages further investor activity, which in turn results in the production of more data. Moreover, differentiating pricing based on reasonable distinctions among consumers cannot be considered unfair under the Act, since the Commission has approved numerous instances of such distinctions. If the Commission were to adopt such a

prohibition, therefore, it would seem to be driven by a concern that exchanges might use bundled data pricing in an anticompetitive manner.<sup>21</sup>

This concern would be reasonable only if the exchange actually enjoyed substantial market power in the data segment of the market and could use it to attempt to reduce competition in the transactions segment. Thus, if all market participants needed data from a particular exchange to operate, and the exchange conditioned low data fees on market participants directing order flow to the exchange, the exchange might attempt to use its control over data to monopolize trading as well. These conditions are not present here, nor is it likely that they could ever arise in these markets. First, an exchange that attempted to restrict the provision of data to disfavored recipients would be restricting access to one of the key mechanisms by which the exchange attracts orders to its matching engine. Moreover, as discussed in detail throughout this filing, the market participants with the most demand for an exchange's data are the ones that actually trade on that exchange, but no one is required to trade on any particular exchange or to consume its data. Indeed, no single exchange controls proprietary data that is indispensable to any particular market participant. Therefore, an effort to use pricing to "penalize" market participants for sending orders to other venues would likely succeed only in driving more orders to those venues and cutting demand for data as well. Finally, because the marginal cost of

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<sup>21</sup> Another possibility is that the Commission might somehow conclude that transactions and data must be priced in isolation of one another, despite their wool/mutton nature, merely to ensure that data consumers who do not use transaction services pay the same fees as those who do. There is nothing in the Act that speaks directly to maintaining a dichotomy between products in establishing their prices, and the Act clearly allows differential pricing within a product category. Nor would it be reasonable for the Commission to conclude that fairness mandates that consumers with different cost and benefit profiles nevertheless pay the same fees. Thus, before the Commission concludes that a particular price differential is "unfair," it should first conclude that the differential lacks a reasonable basis in fact. NASDAQ respectfully maintains that the Commission may not reach such a conclusion in this instance.

selling data to one more customer is zero or close to zero, exchanges have every interest in selling as much data as possible, in order to ensure that they cover their high fixed costs. As a result, exchanges readily sell data to market participants and also to non-market participants that direct no order flow to the exchange at all. Penalizing “disloyal” consumers of data would do nothing more than diminish the exchange’s revenue opportunities.

Under traditional antitrust analysis, pricing systems under which the prices for two products are “bundled” have generally been found to be beneficial to consumers, rather than anticompetitive. A court will not uphold a challenge to bundled pricing unless it is clear that a party has market power in one product and is using the bundled pricing to extend its market power to another product. “Buyers often find package sales attractive; a seller’s decision to offer such packages can merely be an attempt to compete effectively – conduct that is entirely consistent with the Sherman Act.” Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 12 (1984). As noted in the recent report of a bipartisan commission on antitrust law,<sup>22</sup> “[l]arge and small firms, incumbents, and new entrants use bundled discounts and rebates in a wide variety of industries and market circumstances. Because they involve lower prices, bundled discounts and bundled rebates typically benefit consumers.” The report noted that bundled discounts can be used appropriately to reduce the seller’s costs, to improve the quality of products, to advertise the benefits of related products, and to increase demand for a product. If, as is the case here, the markets for both bundled products are competitive, bundled pricing will not give rise to any competitive concerns.

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<sup>22</sup> Report and Recommendations of the Antitrust Modernization Commission (April 2007) (available at [http://govinfo.library.unt.edu/amc/report\\_recommendation/amc\\_final\\_report.pdf](http://govinfo.library.unt.edu/amc/report_recommendation/amc_final_report.pdf)).

Nevertheless, since the Act clearly bars discrimination that is unfair, it would be reasonable for the Commission to disapprove fees or other conditions to access that appear to have anticompetitive aims, such as rules that selectively prohibit some parties from having access to data. The Commission should not, however, block efforts by exchanges to reduce their prices merely because they do not cut prices “across the board.” As the Supreme Court has recognized, “cutting prices in order to increase business often is the very essence of competition.” Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 594 (1986). “Mistaken inferences in cases” involving alleged harm from low prices “are especially costly, because they chill the very conduct the antitrust laws are designed to protect.” Matsushita, 475 U.S. at 594. In this case, disapproval of NASDAQ’s proposed fee reductions would leave the fees for NASDAQ depth products untouched: consumers that would have paid lower fees under the proposal will continue to pay higher fees, and other consumers will pay exactly what they do now, and exactly what they would have paid if the proposal had gone into effect. It is difficult to see how the interests of any parties, or of the marketplace as a whole, would be served by that outcome.

### Conclusion

This filing reduces prices for NASDAQ market data and for trading on NASDAQ. It is designed to promote NASDAQ’s and the Commission’s goal of better serving retail investors whose participation in NASDAQ’s market benefits NASDAQ, its listed companies, its market quality, and the quality of its data products. It is also a competitive response to other trading venues. In short, NASDAQ is cutting prices for customers that are highly valued to NASDAQ and are important to the health of U.S. capital market.

## 2. Statutory Basis

NASDAQ believes that the proposed rule change is consistent with the provisions of Section 6 of the Act.<sup>23</sup> In particular, NASDAQ believes that the proposal is consistent with Section 6(b)(4) of the Act,<sup>24</sup> in that it provides an equitable allocation of reasonable fees among users and recipients of the data, Section 6(b)(5) of the Act,<sup>25</sup> in that it is not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, Section 6(b)(8) of the Act,<sup>26</sup> in that it does not impose any burden on competition not necessary or appropriate in the furtherance of the purposes of the Act, and Rule 603(a) of Regulation NMS,<sup>27</sup> in that it provides for distribution of information with respect to quotations for or transactions in an NMS stock on terms that are fair and reasonable and are not unreasonably discriminatory. In adopting Regulation NMS, the Commission granted self-regulatory organizations and broker-dealers<sup>28</sup> increased authority and flexibility to offer new and unique market data to the public. It was believed that this authority would expand the amount of data available to consumers, and also spur innovation and competition for the provision of market data.

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<sup>23</sup> 15 U.S.C. 78f.

<sup>24</sup> 15 U.S.C. 78f(b)(4).

<sup>25</sup> 15 U.S.C. 78f(b)(5),

<sup>26</sup> 15 U.S.C. 78f(b)(8).

<sup>27</sup> 17 CFR 202.603(a).

<sup>28</sup> It should be stressed that Rule 603, 17 CFR 202.603(a), both allows broker-dealers to distribute their own data, singly or on an aggregated basis, and generally subjects them to the same regulatory standards as exchanges. Thus, any broker or dealer that distributes information must do so on terms that are not unreasonably discriminatory, and any broker or dealer that distributes information for which it is the exclusive source must do so on terms that are fair and reasonable. As a result, to the extent that the Commission establishes procedures or legal standards applicable to exchange data, it must apply the same procedures and standards to broker-dealer data.

NASDAQ Depth Data Products are precisely the sort of market data product that the Commission envisioned when it adopted Regulation NMS. The Commission concluded that Regulation NMS—by lessening regulation of the market in proprietary data—would itself further the Act’s goals of facilitating efficiency and competition:

[E]fficiency is promoted when broker-dealers who do not need the data beyond the prices, sizes, market center identifications of the NBBO and consolidated last sale information are not required to receive (and pay for) such data. The Commission also believes that efficiency is promoted when broker-dealers may choose to receive (and pay for) additional market data based on their own internal analysis of the need for such data.<sup>29</sup>

By removing unnecessary regulatory restrictions on the ability of exchanges to sell their own data, Regulation NMS advanced the goals of the Act and the principles reflected in its legislative history. If the free market should determine whether proprietary data is sold to broker-dealers at all, it follows that the price at which such data is sold should be set by the market as well.

The recent decision of the United States Court of Appeals for the District of Columbia Circuit in NetCoalition [sic] v. SEC, No. 09-1042 (D.C. Cir. 2010) upheld the Commission’s reliance upon competitive markets to set reasonable and equitably allocated fees for market data. “In fact, the legislative history indicates that the Congress intended that the market system ‘evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed’ and that the SEC wield its regulatory power ‘in those situations where competition may not be sufficient,’ such as in the creation of a ‘consolidated transactional reporting system.’ NetCoalition [sic], at 15 (quoting H.R. Rep. No. 94–229, at 92 (1975), as reprinted in 1975 U.S.C.C.A.N. 321, 323). The court agreed with the Commission’s conclusion that “Congress

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<sup>29</sup> Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005).

intended that ‘competitive forces should dictate the services and practices that constitute the U.S. national market system for trading equity securities.’ ”<sup>30</sup>

The Court in NetCoalition, while upholding the Commission conclusion that competitive forces may be relied upon to establish the fairness of prices, nevertheless concluded that the record in that case did not adequately support the Commission’s conclusions as to the competitive nature of the market for NYSEArca’s data product at issue in that case. For the reasons discussed in this filing and in Exhibit 3, however, NASDAQ believes that there is substantial evidence of competition in the marketplace for data that was not in the record in the NetCoalition case, and that the Commission is entitled to rely upon such evidence in concluding that the fees established in this filing are the product of competition, and therefore in accordance with the relevant statutory standards.<sup>31</sup> In addition, as discussed in the “Purpose” section of the filing above, NASDAQ believes that it is not inequitable or unfairly discriminatory to establish discounts for market data fees that take account of a market participant’s transaction volumes.

**B. Self-Regulatory Organization's Statement on Burden on Competition**

NASDAQ does not believe that the proposed rule change will result in any burden on competition. To the contrary, NASDAQ’s proposed price reduction in response to competitive pricing offers is the essence of competition. As the Supreme Court has recognized, “cutting

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<sup>30</sup> NetCoaliton [sic] v. SEC, No. 09-1042 (D.C. Cir. 2010) at p. 16, [sic]

<sup>31</sup> It should also be noted that Section 916 of Dodd- Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) has amended paragraph (A) of Section 19(b)(3) of the Act, 15 U.S.C. 78s(b)(3) to make it clear that all exchange fees, including fees for market data, may be filed by exchanges on an immediately effective basis. Although this change in the law does not alter the Commission’s authority to evaluate and ultimately disapprove exchange rules if it concludes that they are not consistent with the Act, it unambiguously reflects a conclusion that market data fee changes do not require prior Commission review before taking effect, and that a formal proceeding with regard to a particular fee change is required only if the Commission determines that it is necessary or appropriate to suspend the fee and institute such a proceeding.

prices in order to increase business often is the very essence of competition.” Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 594 (1986). NASDAQ is acting pro-competitively by offering more attractive pricing, designed to attract order flow and business away from competing platforms:

When a firm . . . lowers prices but maintains them above predatory levels, the business lost by rivals cannot be viewed as an “anticompetitive” consequence of the claimed violation. A firm complaining about the harm it suffers from nonpredatory price competition “is really claiming that it [is] unable to raise prices.” This is not antitrust injury; indeed, “cutting prices in order to increase business often is the very essence of competition.” The antitrust laws were enacted for “the protection of competition, not competitors.”

Atlantic Richfield Co. v. USA Petroleum Co., 495 U.S. 328, 337-38 (1990) (emphasis in original; citations omitted).

#### Platform Competition is Intense

As the Commission recently recognized,<sup>32</sup> the market for transaction execution and routing services is highly competitive, and the market for proprietary data products is complementary to it, since the ultimate goal of such products is to attract further order flow to an exchange. Order flow is immediately transportable to other venues in response to differences in cost or value and in doing so directly impact the quality and quantity of data at any given platform.

With regard to the market for executions, broker-dealers currently have numerous alternative venues for their order flow, including multiple competing self-regulatory organization (“SRO”) markets, as well as broker-dealers (“BDs”) and aggregators such as the Direct Edge and LavaFlow electronic communications networks (“ECNs”). Each SRO market competes to

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<sup>32</sup> Id.

produce transaction reports via trade executions, and FINRA-regulated Trade Reporting Facilities (“TRFs”) compete to attract internalized transaction reports. It is common for BDs to further and exploit this competition by sending their order flow and transaction reports to multiple markets, rather than providing them all to a single market.

Public markets such as NASDAQ also compete for order flow and executions with dark pools and other ATSS that provide similar services under a lighter regulatory burden.<sup>33</sup> One such disparity that directly affects competition for order flow, executions, and market data is the greater flexibility of dark trading systems and certain ATSS to differentiate between their subscribers. Another is the requirement imposed on exchanges and not upon ATSS to file proposed pricing schedules and changes, thereby subjecting exchanges prices to greater regulatory scrutiny, intervention and delay. NASDAQ has questioned and continues to question whether such disparities remain justified (assuming they once were justified) in light of current competition between exchanges and ATs and including increasingly high levels of executions occurring in ATSS.

Competitive markets for order flow, executions, and transaction reports provide pricing discipline for the inputs of proprietary data products. The large number of SROs, TRFs, and ECNs that currently produce proprietary data or are currently capable of producing it provides further pricing discipline for proprietary data products. Each SRO, TRF, ECN and BD is currently permitted to produce proprietary data products, and many currently do or have announced plans to do so, including NASDAQ, NYSE, NYSEArca, BATS, and Direct Edge.

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<sup>33</sup> See Letter dated April 30, 2010, from Joan Conley, Senior vice President and Corporate Secretary, The NASDAQ Stock Market LLC, to Elizabeth Murphy, Secretary, Securities and Exchange Commission (commenting on regulatory disparities and arbitrage in response to Concept Release on Market Structure).

Any ECN or BD can combine with any other ECN, broker-dealer, or multiple ECNs or BDs to produce jointly proprietary data products. Additionally, non-BDs such as order routers like LAVA, as well as market data vendors can facilitate single or multiple broker-dealers' production of proprietary data products. The potential sources of proprietary products are virtually limitless.

The fact that depth data from ECNs, BDs, and vendors can by-pass SROs is significant in two respects. First, non-SROs can compete directly with SROs for the production and distribution of proprietary data products, as Archipelago, BATS, and DirectEdge did prior to registering as SROs. Second, because a single order or transaction report can appear in an SRO proprietary product, a non-SRO proprietary product, or both, the data available in proprietary products is exponentially greater than the actual number of orders and transaction reports that exist in the marketplace writ large.

Market data vendors provide another form of price discipline for proprietary data products because they control the primary means of access to end users. Although their business models may differ, vendors exercise pricing discipline because they can simply refuse to purchase any proprietary data product that fails to provide sufficient value. NASDAQ and other producers of proprietary data products must understand and respond to these varying business models and pricing disciplines in order to successfully market proprietary data products.

In addition to the competition and price discipline described above, the market for proprietary data products is also highly contestable because market entry is rapid, inexpensive, and profitable. The history of electronic trading is replete with examples of entrants that swiftly grew into some of the largest electronic trading platforms and proprietary data producers: Archipelago, Bloomberg Tradebook, Island, RediBook, Attain, TracECN, BATS Trading, and

Direct Edge. Several ECNs have existed profitably for many years with a minimal share of trading, including Bloomberg Tradebook and LavaFlow.

Competition among platforms has driven NASDAQ continually to improve its platform data offerings and to cater to customers' data needs. For example, NASDAQ has developed and maintained multiple delivery mechanisms (IP, multi-cast, and compression) that enable customers to receive data in the form and manner they prefer and at the lowest cost to them. NASDAQ offers front end applications such as its "Bookviewer" to help customers utilize data. NASDAQ has created TotalView Aggregate to complement TotalView ITCH and Level 2, because offering data in multiple formatting allows NASDAQ to better fit customer needs. NASDAQ offers data via multiple extranet providers, thereby helping to reduce network and total cost for its data products. NASDAQ has developed an online administrative system to provide customers transparency into their data feed requests and streamline data usage reporting. NASDAQ has also expanded its Enterprise License options that reduce the administrative burden and costs to firms that purchase market data.

Despite these enhancements and a dramatic increase in message traffic, NASDAQ's fees for depth-of-book data have remained flat. In fact, as a percent of total customer costs, NASDAQ data fees have fallen relative to other data usage costs -- including bandwidth, programming, and infrastructure -- that have risen. The same holds true for execution services; despite numerous enhancements to NASDAQ's trading platform, absolute and relative trading costs have declined. Platform competition has intensified as new entrants have emerged, constraining prices for both executions and for data.

The proposed rule change is a direct response to this competition, and it is motivated by the conclusion that Tier 1, Tier 2 and Tier 3 Firms provide benefits to NASDAQ and its

customers across business lines and therefore merit pricing incentives to join or remain in these tiers. It recognizes the concern that the order flow and data product use that such firms currently bring to NASDAQ may migrate elsewhere if their contributions are not appropriately recognized. At the same time, if other customers determine that their fees are too high in comparison to those paid by firms qualifying for the discount, they will take their business to other venues. Thus, the proposal must strike a balance between growing and retaining the business of actual and potential Tier 1 and Tier 2 Firms and the business of firms that lack the volume of business to become eligible. In light of the highly competitive nature of these markets, NASDAQ's revenues and market share are likely to be diminished by the proposal if it strikes this balance in the wrong way.<sup>34</sup>

#### The NetCoalition Decision

The court in NetCoalition concluded that the Commission had failed to demonstrate that the market for market data was competitive based on the reasoning of the Commission's NetCoalition order because, in the court's view, the Commission had not adequately demonstrated that competition for order flow adequately constrains the pricing of depth-of-book data.<sup>35</sup> However, the Netcoalition [sic] court did cite favorably an economic study by Ordover and Bamberger which concluded that "[a]lthough an exchange may price its trade execution fees

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<sup>34</sup> The Commission has recognized that an exchange's failure to strike this balance correctly will only harm the exchange. "[M]any market participants would be unlikely to purchase the exchange's data products if it sets fees that are inequitable, unfair, unreasonable, or unreasonably discriminatory.... For example, an exchange's attempt to impose unreasonably or unfairly discriminatory fees on a certain category of customers would likely be counter-productive for the exchange because, in a competitive environment, such customers generally would be able to respond by using alternatives to the exchanges data." Id.

<sup>35</sup> The NetCoalition court did not consider or address the statutory amendments encompassed by the Dodd-Frank Act in any way.

higher and its market data fees lower (or vice versa), because of “platform” competition the exchange nonetheless receives the same return from the two “joint products” in the aggregate.”<sup>36</sup>

Accordingly, NASDAQ is submitting along with this filing additional comments from Ordover and Bamberger expanding upon the impact of platform competition on the pricing of joint products, and in particular on the application of that theory to NASDAQ’s current proposal.

Among the conclusions that Ordover and Bamberger reach are:

NASDAQ is subject to significant competitive forces in setting the prices and other terms of execution services and proprietary data products.

Competition among trading platforms can be expected to constrain the aggregate return each platform earns from the sale of the array of its products, including the joint products at issue here. In particular, cross-platform competition, and the adverse effects from overpricing proprietary information on the volume of trading on the platform, constrain the pricing of proprietary information.

Competitive forces constrain the prices that platforms can charge for non-core market information. A trading platform cannot generate market information unless it receives trade orders. For this reason, a platform can be expected to use its market data product as a tool for attracting liquidity and trading to its exchange.

While, by definition, information that is proprietary to an exchange cannot be obtained elsewhere, this does not enable the owner of such information to exercise monopoly power over that information vis-à-vis firms with the need for such information. Even though market information from one platform may not be a perfect substitute for market information from one

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<sup>36</sup> See NetCoalition at fn. 30.

or more other platforms, the existence of alternative sources of information can be expected to constrain the prices platforms charge for market data.

Besides the fact that similar information can be obtained elsewhere, the feasibility of supra-competitive pricing is constrained by the traders' ability to shift their trades elsewhere, which lowers the activity on the exchange and so in the long run reduces the quality of the information generated by the exchange.

NASDAQ's Platform pricing can be described as a type of "differential pricing" and "bundling." Differential pricing in markets with high fixed costs and low incremental costs is common, efficient, and not anticompetitive. "Bundling" also is common and generally procompetitive.

NASDAQ's joint products are produced under the conditions of high fixed costs, which are also joint and common to a range of products, and low (or zero) marginal or incremental cost of serving an additional customer. In industries with these cost characteristics, charging all customers the same price is not economically efficient.

Additional evidence cited by NYSE Arca in SR-NYSE Arca-2010-097 which was not before the NetCoalition court also demonstrates that availability of depth data attracts order flow and that competition for order flow can constrain the price of market data:

1. Terrence Hendershott & Charles M. Jones, Island Goes Dark: Transparency, Fragmentation, and Regulation, 18 Review of Financial Studies 743 (2005);
2. Charts and Tables referenced in Exhibit 3B to that filing;
3. PHB Hagler Bailly, Inc., "Issues Surrounding Cost-Based Regulation of Market Data Prices;" and
4. PHB Hagler Bailly, Inc., "The Economic Perspective on Regulation of Market Data."

NASDAQ also submits that in and of itself, NASDAQ's decision voluntarily to cap fees on existing products is evidence of market forces at work. The instant proposal does just that, creating an expanded enterprise license on two product classes. Retail investors will be the primary beneficiaries.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were either solicited or received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective pursuant to Section 19(b)(3)(A)(ii) of the Act.<sup>37</sup> At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASDAQ-2011-010 on the subject line.

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<sup>37</sup> 15 U.S.C. 78s(b)(3)(a)(ii).

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2011-010. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission,<sup>38</sup> all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to

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<sup>38</sup> The text of the proposed rule change is available on the Commission's Web site at <http://www.sec.gov/rules/sro.shtml>.

make available publicly. All submissions should refer to File Number SR-NASDAQ-2011-010 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>39</sup>

Elizabeth M. Murphy  
Secretary

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<sup>39</sup> 17 CFR 200.30-3(a)(12).