



June 30, 2004

Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609

Re: Regulation NMS - File No. S7-10-04

Dear Mr. Katz:

The Securities Industry Association<sup>1</sup> (“SIA” or “Association”) appreciates the opportunity to comment on the Securities and Exchange Commission’s (“SEC” or “Commission”) proposed Regulation NMS under the Securities Exchange Act of 1934 (“Exchange Act”).<sup>2</sup> Market structure issues are critical for public investors, SIA’s membership and the securities industry as a whole. The discussion stimulated by the NMS Release comes at a crucial stage in the evolution of the U.S. securities markets and, therefore, provides a special opportunity to promote even greater market efficiency and quality for all market participants. SIA commends the Commission and its staff for their efforts to resolve these complex and interrelated questions.

## **I. Executive Summary**

In response to the NMS Release, SIA assembled two working groups, drawn from SIA’s Market Structure, Trading and Federal Regulation Committees as well as the

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<sup>1</sup> The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker’s Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated \$209 billion in U.S. revenue and \$278 billion in global revenues. (More information about SIA is available on its home page: [www.sia.com](http://www.sia.com).)

<sup>2</sup> Exchange Act Release No. 49325 (Feb. 26, 2004), 69 Fed. Reg. 11126 (Mar. 9, 2004) (“NMS Release”) and Exchange Act Release No. 49749 (May 20, 2004), 69 Fed. Reg. 30142 (May 26, 2004) (“Supplemental Release”).

Market Data Subcommittee of the Technology and Regulation Committee and representing a broad range of its members, to study the regulatory issues presented by the NMS Release. SIA's Board has reviewed and approved the conclusions of these two working groups. After analyzing and debating the market structure issues for several months, SIA reached the following conclusions regarding each of the SEC's four primary proposals in the NMS Release:

- Intermarket Price Protection. SIA recommends that intermarket price protection apply to those best bids and offers that are firm and accessible across all market centers for all Nasdaq and listed stocks. To address certain practical trading issues, SIA also advocates certain exceptions to the general intermarket price protection rule, including exceptions for those who choose to opt out (provided such an exception does not include the requirements to provide the national best bid or offer ("NBBO") or order-by-order disclosure), intermarket sweep orders, large block trades, benchmark trades, trades within a *de minimis* three-second window, and other miscellaneous items.<sup>3</sup> SIA believes that such intermarket price protection is in the best interest of investors because it fosters accurate price discovery, facilitates market integrity and encourages technological innovation.
- Intermarket Access. Because efficient intermarket access is critical for price protection specifically as well as for the markets generally, we applaud the Commission's focus on the various aspects of such access: linkages and connectivity, access fees, and locked and crossed markets. Specifically:
  - Linkages/Connectivity. SIA is in favor of the Commission's proposed market access standards for private linkages, but notes that issues related to certain small or relatively inactive markets remain to be resolved.
  - Access Fees. SIA supports the Commission's efforts to resolve the long-standing issues regarding access fees, but is divided over the optimal solution. Some members view the SEC's *de minimis* access fee proposal as a fair compromise, while others continue to consider such a solution as inappropriate. Nonetheless, there is general support regarding the need for some regulation of access fees associated with quotes that are hit by orders routed away to obtain access to the NBBO to fulfill intermarket price protection obligations.<sup>4</sup>

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<sup>3</sup> As discussed in more detail below, certain practical trading issues in the current market environment affect the configuration of the proposed intermarket price protection and its exceptions. As the SEC states, "[i]n a fully efficient market with frictionless access and instantaneous executions, trading through a better-displayed bid or offer should not occur." See, e.g., page 11 and footnote 20 below.

<sup>4</sup> See footnote 61 for a discussion of the dissenting opinion of some SIA member firms on this point.

- Locked and Crossed Markets. SIA supports the SEC's proposed rule to minimize locked and crossed markets, subject to certain additional exceptions.
- Sub-Penny Quoting. SIA supports the Commission's proposed ban on sub-penny quoting, as we are concerned with the various adverse effects of sub-penny pricing (e.g., stepping ahead, loss of depth, and decreased price clarity).
- Market Data. The level of fees charged for consolidated market data is a critical market structure issue that should be addressed now, and not as a side issue. Market data issues have been pending before the Commission since 1999. SIA is deeply concerned that the SEC's exclusive focus on the allocation of market data revenues in the NMS Release represents a lost opportunity to address the true problems caused by current market data fees. SIA believes that market data fees are too high, and that their excessive levels are made possible by the opaque governance structures of the three joint industry plans<sup>5</sup> ("Plans") and a lack of transparency in the fee setting process. As a result, SIA advocates cost-based market data fees, and a separation of regulatory costs from market data costs to ensure adequate funding of the former and appropriate levels for the latter. These changes should be supported by transparent Plan governance and fee setting processes, and streamlined contractual arrangements between firms and the three networks that disseminate consolidated market information<sup>6</sup> ("Networks").

We elaborate on each of these conclusions in the discussion below.

## II. Guiding Principles

To provide a guide for its discussions, SIA identified the following factors as vital to modern market structure:

- Foster Investor Protection. Investor protection has been a cornerstone of the U.S. securities laws since these laws were enacted in the 1930s. The Exchange Act

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<sup>5</sup> See NMS Release at 11176, n. 270 (describing the three joint industry plans: "(1) the CTA Plan, which is operated by the Consolidated Tape Association and disseminates transaction information for exchange-listed securities; (2) the CQ Plan, which disseminates consolidated quotation information for exchange-listed securities; and (3) the Nasdaq UTP Plan, which disseminates consolidated transaction and quotation information for Nasdaq-listed securities").

<sup>6</sup> See NMS Release at 11176 (describing the three Networks: "(1) Network A for securities listed on the NYSE; (2) Network B for securities listed on the Amex and other national securities exchanges; and (3) Network C for securities traded on Nasdaq").

clearly sets forth this important goal, stating that it was adopted “to insure the maintenance of fair and honest markets.”<sup>7</sup> Any regulatory approach must continue to make sure that the public is protected, thus allowing the U.S. markets to flourish.

- Encourage Fair Competition. Free markets and a competitive environment should determine the fundamental structure of the securities markets. Any regulation should be sufficiently flexible to avoid stifling the development of new trading practices and technological innovations by competing market centers.
- Promote Efficient Intermarket Trading. We advocate regulatory measures that will facilitate the goal of efficient intermarket trading. In particular, we believe that fostering effective intermarket executions and enhancing market access will ensure that all investors’ orders—both retail and institutional—are executed in the manner most beneficial to the investor.
- Maintain Fair and Orderly Markets. We believe that any new regulation must contribute to the maintenance of fair and orderly markets, a primary objective of Congress in mandating the national market system.
- Support Equal Regulation. We believe that there should be fair and consistent regulation across market centers. Therefore, we agree with the Commission’s intent in the NMS Release of furthering the statutory objective of assuring equal regulation of the markets.<sup>8</sup>
- Ensure Quality and Fairly Priced Market Data. As the basis for effective price discovery and the successful functioning of the U.S. securities markets, we believe that market data must be both of high quality and cost-effective.

Using these principles as a basis, SIA provides the Commission with the following comments on the NMS Release. SIA encourages the Commission to incorporate these suggestions, as discussed in more detail below, when formulating any final rules.

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<sup>7</sup> Section 2 of the Exchange Act.

<sup>8</sup> See, e.g., Section 3(a)(36) of the Exchange Act (“[a] class of persons or markets is subject to ‘equal regulation’ if no member of the class has a competitive advantage over any other member thereof resulting from a disparity in their regulation under this title which the Commission determines is unfair and not necessary or appropriate in furtherance of the purposes of this title”); Section 11A(c)(1)(F) of the Exchange Act (“assure equal regulation of all markets for qualified securities and all exchange members, brokers, and dealers effecting transactions in such securities”).

### **III. Intermarket Price Protection**

#### **A. Introduction**

The SIA agrees with the Commission's goal of "affirm[ing] the fundamental principle of price priority, while also addressing . . . the inherent difference in the nature of prices displayed by automated markets, which are immediately accessible, compared to prices displayed by manual markets."<sup>9</sup> The Association believes that intermarket price protection of all firm and accessible quotes is not only beneficial, but essential, to the markets. We believe such intermarket price protection fosters accurate price discovery and facilitates market integrity by encouraging aggressive quoting and enhanced order interaction across the multiple competing market centers. Accordingly, markets should be encouraged to provide routing and execution mechanisms that facilitate such price protection. Such an approach will ensure that the public policy goal of fostering the overall best market structure for the modern age, given all of its new technology and innovation, is achieved.<sup>10</sup>

#### **B. Operation of Intermarket Price Protection**

We recommend that intermarket price protection apply only to those best bids or offers that are firm and accessible (the "intermarket price protection rule"). Therefore, if a posted best quote is firm and accessible, the intermarket price protection applies. Correspondingly, no intermarket price protection should be provided to quotes that are not firm and accessible. Therefore, the right to trade without reference to a quote that is not firm and accessible would be absolute.<sup>11</sup> Such an approach improves price discovery while taking into account the realities of the existing market structure.<sup>12</sup>

Accordingly, the definition of a firm and accessible quote is of the utmost importance. An overly broad definition, which includes non-firm or inaccessible quotes,

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<sup>9</sup> NMS Release at 11127.

<sup>10</sup> "I would ask that you put on your public policy hats for today's hearing . . . [y]ou can help us by identifying the public policy goods that can be achieved by enacting the right and appropriate market structure rule proposals." Chairman William H. Donaldson, Opening Statement at the Regulation NMS Hearing, New York, NY (Apr. 21, 2004) ("NMS Hearing") *available at* <http://www.sec.gov/news/speech/spch042104whd.htm>.

<sup>11</sup> Regardless of the application of such a price protection rule, broker-dealers will continue to have a duty to seek to obtain best execution of their customers' orders.

<sup>12</sup> This is similar to the exception for manual quotes that the SEC suggested in the Supplemental Release. See Supplemental Release at 30143.

will undermine or negate the intent of the intermarket price protection. We recommend defining a “firm and accessible quote” as a quote that is:

- (1) updated automatically;
- (2) subject to execution up to its total displayed size (depending on the size of the order) when an order is routed to that quote to fulfill intermarket price protection obligations (“intermarket sweep order”);
- (3) subject to automatic and immediate execution or cancellation on a computer-to-computer basis with no human intervention;<sup>13</sup> and
- (4) accessible to all market participants, directly or indirectly.<sup>14</sup>

The concept of “accessible” necessarily demands that the quote is visible as well as reachable on a non-discriminatory basis. Indeed, the accessibility of the quote is a critical component; intermarket price protection of a quote is impossible if the quote cannot be reached. Therefore, the market access requirements, as discussed in Section IV of this letter, are inextricably tied to the intermarket price protection rule. One cannot be adopted without the other.<sup>15</sup>

We believe that the SEC, not the individual market centers themselves, should set standards or threshold conditions used to determine whether a quote on any particular market would qualify as “firm and accessible.” In addition, we believe that this approach would be technically easy to accomplish given the current capabilities of the relevant order handling systems. The markets could disseminate a marker with their quote

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<sup>13</sup> Consistent with its obligation to seek to obtain best execution, a broker-dealer may decide to route to a market where it reasonably believes, based on its ongoing regular and rigorous review of order handling, its customer orders will receive best execution. In making its routing decision, a broker-dealer may, of course, not only consider Rules 11Ac1-5 and 11Ac1-6 under the Exchange Act, but also the legal obligations of the receiving market to comply with any appropriate intermarket price protection requirement, including the requirement to, in effect, match a superior price at another market or send an order to that market. See, e.g., Exchange Act Release No. 43590 (Nov. 17, 2000), 65 Fed. Reg. 75414 (Dec. 1, 2000) (noting that, when evaluating the execution quality of a market center, it is important to know how a market center handles all orders, including those it routes away).

<sup>14</sup> A “firm and accessible quote” would not include a quote subject to limitations, such as limitations on who can obtain access to the quote and how often (e.g., limiting the number of orders from the account of the same individual or beneficial owners that could be sent to the market for execution within a certain time frame), or limitations on the size of a possible execution, other than the full size of the best bid or offer displayed by the market.

<sup>15</sup> Indeed, we believe that the market access issues are inextricably linked with how the price protection approach would be implemented. Therefore, we strongly believe that SEC action regarding market access should not be severed from SEC action regarding trade-throughs.

through the consolidated system indicating whether the quote is firm and accessible.<sup>16</sup> Hybrid markets would be responsible for changing the marker when they shift from a fast quote to a slow quote or vice versa. In addition, such markets would be responsible for removing any non-accessible quotes from the NBBO.

We believe that such an intermarket price protection rule could be broadly applied across the securities markets, thereby allowing the SEC to attain the valuable goal of regulatory uniformity. The intermarket price protection rule should apply to any purchase or sale of any security (other than an option) that is listed on a national securities exchange or association during regular trading hours. It also should apply across market centers—to all national securities exchanges, national securities associations and other order execution facilities.<sup>17</sup> In addition, the policies and procedures reasonably designed to ensure price protection that each market center must establish, maintain and enforce must be consistent to avoid creating a significant compliance issue for broker-dealers.<sup>18</sup>

Because the intermarket price protection rule would protect only firm and accessible quotes, we believe that few market participants will be interested in the use of broad exceptions to the rule. We believe, however, that certain exceptions would be necessary to facilitate particular investment and trading strategies and, therefore, recommend the following exceptions to the general rule:

(i) Opt-Out Exception. We recommend the inclusion of the SEC's proposed opt-out exception, provided it does not contain the requirements to provide the NBBO or to obtain order-by-order consent (as discussed in Section III.C below). Not only will this exception act as a real incentive for markets to be as efficient as possible,<sup>19</sup> but it also will

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<sup>16</sup> Supplemental Release at 30142-43 (citing NMS Hearing Transcript at 57, 142-144, 157-158) (panelists noting that existing order routing technologies were capable of identifying such a marker on a quote-by-quote basis). See also Exchange Act Release No. 49404 (Mar. 11, 2004), 69 Fed. Reg. 12727 (Mar. 17, 2004) (proposing rule to require NASD members to append the .PRP modifier to reports of transactions in listed securities when the price of a trade is based on a prior point in time); Exchange Act Release No. 41606 (July 8, 1999), 64 Fed. Reg. 38226 (July 15, 1999) (approving similar .PRP rule for transactions in Nasdaq securities). Of course, the SEC should provide notice and the opportunity to comment on the quote dissemination methodology.

<sup>17</sup> We agree that an "order execution facility" should be broadly defined to include national securities exchanges and associations that operate a facility that executes orders, ATSS, exchange specialists and market makers, OTC market makers, block positioners and any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent. See NMS Release, Proposed Rule 600(b)(50).

<sup>18</sup> Correspondingly, the SEC must address those aspects of the Intermarket Trading System Plan ("ITS Plan") that would be inconsistent with the intermarket price protection rule. Leaving a conflicting trade-through standard in ITS will be confusing, increase compliance costs, and limit any benefits to investors of the new price protection rule.

<sup>19</sup> NMS Hearing Transcript at 28, 35-36, 43.

facilitate certain trading strategies and technologies as well as trading under certain market conditions.<sup>20</sup>

Despite the fact that such an opt-out exception ostensibly would cover all possible needs for more particularized exceptions to the intermarket price protection rule, we believe that, as a practical matter, the opt-out exception may not be used, or offered to customers, on a regular basis. For commercial, legal and practical reasons, market participants may simply elect to avoid the use of a broad opt-out. We assume that, like any other order type, an order execution facility may choose to make the opt-out available to their customer base, or not, as they see fit. If, as a practical matter, the opt-out exception is not available to investors, certain trading strategies would demand a more flexible approach than the basic intermarket price protection rule provides. Therefore, we believe that additional specific exceptions are necessary to accommodate varied trading efforts even if the opt-out exception is adopted. These additional exceptions include:

(ii) Intermarket Sweep Order. We support the SEC's proposed Rule 611(b)(7), which provides an exception for those instances in which an order execution facility sends an order to execute against a better-priced order displayed on another market at the same time or prior to executing an order in its own market at an inferior price. Such an exception will facilitate the use of smart routing technology, provided the exception is revised to address certain technical issues related to the use of intermarket sweep orders.

An "intermarket sweep order" could arise where an order execution facility wants to be able to route an order(s) to execute against any better-priced bid(s) or offer(s) on other market center(s) at the same time as or prior to executing the remaining balance in its own market at an inferior price, or a market participant could wish to execute [some or all] of an order it holds by sending orders to interact with the best bids and offers displayed on other market centers.<sup>21</sup> As the Commission notes in the Supplemental Release, "a market center that receives one part of an 'intermarket sweep order' would not know that other 'sweep' order(s) have been sent to other market centers."<sup>22</sup> As a result, the receiving market may "route the order it received to another market displaying a better price, even though the order router already has attempted to take out these better

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<sup>20</sup> We recognize that, if the SEC were to embrace the firm and accessible quote approach as well as the various exceptions we advocate, it would mitigate the need for a general opt-out exception. Correspondingly, if the Commission failed to embrace such an approach and the various exceptions, then there would be a much greater need to address various trading situations through a general opt-out provision.

<sup>21</sup> Supplemental Release at 30145, n. 32. See also NMS Hearing Transcript at 53-54, 145-146.

<sup>22</sup> Supplemental Release at 30145.

prices.”<sup>23</sup> To remove this unintended market disruption, we recommend the use of specially designated intermarket sweep orders, which would alert other markets to the sweep nature of the order. Such an order should carry a flag that can be identified by routing technologies and that indicates that the order execution facility has sent order(s) to take out other relevant quotes.<sup>24</sup> Therefore, the receiving market center would be able to execute such a flagged order without regard to whether a better price was displayed on another market center.

We emphasize that such intermarket sweep orders differ from other types of orders routed to a specific market venue (e.g., exchanges as well as alternative trading systems (“ATS”) and other broker-dealers). Intermarket sweep orders should be specially marked because they are utilized to obtain access to quotes in order to comply with any intermarket price protection requirement. Such orders are pivotal to the operation of an intermarket price protection structure because they facilitate efficient access to the top-of-book of each order execution facility.

(iii) Large Block Exception. We recommend that the intermarket price protection rule contain a block exception for orders of 25,000 shares or more.<sup>25</sup> Such an exception would provide institutions and other large traders with the ability to execute a block immediately at a price outside the quote. This would allow traders to avoid parceling the block out over time in a series of transactions, which increases transaction costs and the likelihood of potentially inferior execution prices.

(iv) Benchmark Trades. We also recommend that the SEC include a specific exception for trades that occur at a price that is unrelated to the current market price. Examples of such benchmark trades are volume weighted average pricing (“VWAP”) trades, stops,<sup>26</sup> certain derivative-related trades, and other similar benchmark trades.<sup>27</sup> In this regard, we suggest that the SEC encourage the use of special reporting flags for benchmark trades to indicate to the market that they are excluded from the intermarket price protection rule.<sup>28</sup> Of course, transactions underlying benchmark trades would be required to conform to intermarket price protection requirements.

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<sup>23</sup> Id.

<sup>24</sup> We believe that the form of the quote flags or markers discussed in this letter should be subject to notice and request for comment by the SEC.

<sup>25</sup> See, e.g., NYSE Rule 72(b) (clean cross rule using 25,000 share minimum).

<sup>26</sup> An agreement to “stop” securities at a specified price is a guarantee of the purchase or sale of the securities at that price. See, e.g., NYSE Rule 116.

<sup>27</sup> This exception would be defined broadly enough to accommodate miscellaneous items, such as the use of monetary adjustment accounts.

<sup>28</sup> See footnote 16 for a discussion of such flags.

(v) De Minimis Exception. We are concerned with false positive trade-throughs resulting from flickering quotes, clocks that are not synchronized, delays in quotation information, and other practicalities of the markets. Therefore, we recommend a *de minimis* exception that provides a plus or minus three-second window for the intermarket price protection rule. Of course, broker-dealers still would be subject to their general duty to seek to obtain best execution of their customers' orders.

(vi) Miscellaneous Exceptions. We also believe that the intermarket price protection rule should incorporate the various miscellaneous exceptions proposed by the Commission for its trade-through rule.<sup>29</sup> We believe that these exceptions, which relate to system malfunctions, non-regular way contracts, unusual markets, openings, re-openings and crossed markets, are appropriate. The inclusion of all of these exceptions would allow market participants to continue to trade efficiently in the new environment.<sup>30</sup> We do not expect that these limited exceptions will have a material adverse effect on price discovery or aggressive quoting practices.

We recognize that the intermarket price protection rule does not protect quotes that are not eligible for immediate execution. We believe, however, that such an approach strikes the appropriate balance between the goal of intermarket price protection and the realities of the current marketplace. In addition, the intermarket price protection rule provides appropriate rewards to, and imposes appropriate burdens on, market participants to improve the U.S. market structure as a whole.<sup>31</sup> At the same time, this proposal preserves the ability of floor-based markets to offer a robust auction market for those participants that wish to participate in those markets.<sup>32</sup>

Overall, the intermarket price protection rule creates the correct incentive scheme. It rewards those quotes that are most beneficial to price discovery—those that are firm and accessible. We believe that it is logical to require market participants to honor only “real” quotes, i.e., those quotes that can be executed against. This approach rewards those market participants who take the affirmative risk to add to price discovery in a

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<sup>29</sup> NMS Release, Proposed Rules 611(b)(1)-(6).

<sup>30</sup> We do not believe that a fast market exception to the intermarket price protection rule is necessary. “Slow” quotes will not be provided any price protection in the first place and, therefore, no fast market exception is necessary.

<sup>31</sup> This action is in keeping with SEC’s practice of engaging in proactive regulation when it is “necessary to address practices that inhibit or distort competition and stand in the way of the development of fairer and more efficient trading mechanisms.” Exchange Act Release No. 42450 (Feb. 23, 2000), 65 Fed. Reg. 10577 (Feb. 28, 2000).

<sup>32</sup> See NMS Hearing Transcript at 57 (panelist expressing the view that focusing on automated quotes would provide market centers with more flexibility to evolve toward automation).

committed manner. Correspondingly, it is logical to discourage “phantom quotes,” *i.e.*, indicative quotations that may or may not provide an incoming order with an execution.<sup>33</sup> Intermarket price protection of indicative quotes would only do a disservice to the market.

By encouraging firm and accessible quotes, intermarket price protection also fosters the development of better trading and routing technology that enhances market efficiency.<sup>34</sup> The SEC stated in the NMS Release that “in a fully efficient market with frictionless access and instantaneous executions, trading through a better-displayed bid or offer should not occur.”<sup>35</sup> We agree with this principle and, therefore, support intermarket price protection because it will bring the markets closer to this goal of efficiency—by rewarding market centers that provide effective intermarket executions and intermarket access.<sup>36</sup> Correspondingly, it will “discipline markets that provide slow executions or inadequate access to their markets” or otherwise fail to keep pace with the competitive or technological environment of the 21st century.<sup>37</sup> This will ensure that all investors’ orders—both retail and institutional—are executed in the manner most beneficial to the investor, thereby realizing the national market system goals of “economically efficient execution of securities transactions” and the “execut[ion of] investors’ orders in the best market” possible.<sup>38</sup>

Finally, we believe that intermarket price protection improves the ability of different market structures to compete. We highly value the competition between markets and credit much of the success and innovation of the U.S. markets to that competition. Therefore, we have considered carefully any possible adverse effects of intermarket price protection on this competitive framework and have concluded that the effects will only be beneficial. Because the intermarket price protection rule does not

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<sup>33</sup> NMS Release at 11134 and n. 47. We note, however, that the concept of “phantom quotes” does not encompass legitimate uses of indications of interest, which are a beneficial tool in the marketplace.

<sup>34</sup> Congress concluded that “[n]ew data processing and communications techniques create the opportunity for more efficient and effective market operations.” Section 11A(a)(1)(B) of the Exchange Act.

<sup>35</sup> NMS Release at 11129. Indeed, some member firms believe a price protection rule will become unnecessary or redundant once the market structure issues have been addressed.

<sup>36</sup> Congress concluded that “[t]he linking of all markets for qualified securities will . . . foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors’ orders, and contribute to best execution of such orders.” Section 11A(a)(1)(D) of the Exchange Act.

<sup>37</sup> NMS Release at 11138.

<sup>38</sup> Section 11A(a)(1)(C) of the Exchange Act.

require market centers to adopt a particular business model,<sup>39</sup> it will allow manual and hybrid markets to continue to operate as they do now and provide electronic markets the necessary leeway to compete more fairly with manual markets.

The mere discussion of enhanced intermarket price protection of firm and accessible quotes on electronic trading systems already has encouraged market participants to make voluntary improvements and upgrades to their trading systems and methods. Those markets that are currently lacking effective automatic intermarket execution capabilities have indicated that they are developing plans to upgrade these capabilities to accommodate such executions.<sup>40</sup> We applaud this move and believe that the actual adoption of the intermarket price protection rule will undoubtedly accelerate this process for the benefit of all investors.

### **C. Comment on the SEC's Proposed Trade-Through Rule**

We believe that the intermarket price protection described above will advance the SEC's public policy goals in the most appropriate fashion. We recognize, however, that the Commission has proposed a system-wide trade-through rule that differs from the intermarket price protection solution. We believe that the SEC's proposed rule will result in implementation and compliance difficulties, increased costs and adverse market incentives.<sup>41</sup> Therefore, were the Commission to adopt its proposed trade-through rule (despite the arguments in opposition to the rule), we think that the proposed exceptions to the rule and certain revisions therein become all the more critical. Discussed below are our greatest concerns with the proposed rule.

#### **1. Opt-Out Exception**

The SEC has proposed an exception to the trade-through rule that would permit an investor to opt out of the trade-through protections.<sup>42</sup> We generally believe that this opt-out exception is an important tool for investors with different investing strategies and

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<sup>39</sup> See NMS Release at 11138 and 11155.

<sup>40</sup> See NYSE Testimony and Amex Testimony, NMS Hearing *available at* <http://www.sec.gov/spotlight/regnms.htm>. See also "Highway to Hybrid," Securities Industry News (May 3, 2004) (asserting that "[b]y the end of the year, virtually all U.S. equity and options exchanges will be electronic or hybrid to respond to competition and regulatory reforms").

<sup>41</sup> From many reports, the enforcement of the existing trade-through rule is problematic. Indeed, based on these reports, it does not appear that comprehensive trade-through statistics are available, thereby making evaluations of this rule difficult. We therefore are concerned with broadening the application of this rule to the entire market.

<sup>42</sup> NMS Release, Proposed Rule 611(b)(8).

methods (e.g., those who value speed and large traders).<sup>43</sup> We strongly oppose, however, the SEC's proposed conditions for making use of the opt-out. The requirements to provide the NBBO at the time of the trade and to obtain the necessary consent on an order-by-order basis should be removed from the opt-out exception. Not only are these requirements cumbersome and costly, but they are unnecessary to protect investors.

**a. Provision of NBBO**

In its proposal, the SEC would require that a broker-dealer disclose to its customers that have chosen to opt out the NBBO at the time of execution for each order for which a customer opted out.<sup>44</sup> We believe that this requirement should be deleted from the proposal because it is confusing for investors, impractical and expensive. First, we believe that the provision of the NBBO may be more misleading than useful for investors. Such disclosure would suggest to the investor that the investor would have obtained the disclosed price if the investor had not opted out, which may or may not be the case. Any number of trading or market conditions (e.g., fast markets in a decimal environment, minimal quote depth, stale quotes and imperfect clock synchronizations) could have prevented the investor from realizing that particular price.

The proposal also raises significant practical difficulties. Currently, broker-dealer systems do not have the capability to place the NBBO on a confirmation or monthly statement as proposed. Therefore, substantial system modifications, performed at a significant cost, would be necessary to implement the NBBO provision.<sup>45</sup> We believe that the implementation difficulties and costs of the NBBO requirement significantly outweigh the benefits to investors, which are questionable at best.

**b. Order-by-Order Consent**

Similarly, we believe that the SEC's proposed requirement that the broker-dealer obtain informed consent from each investor who chooses to opt out of the trade-through protections on an order-by-order basis is too restrictive and onerous. Therefore, we recommend that the SEC introduce greater flexibility into its informed consent requirement, allowing investors to provide consent on a global basis as well as on an order-by-order basis.

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<sup>43</sup> Some firms, however, believe that, as a practical matter, the opt-out exception will not be used because market participants always will seek to obtain the best price. Other member firms believe that the opt-out should not be available at all where a quote resides in a so-called fast market or is a fast quote.

<sup>44</sup> NMS Release, Proposed Rule 611(c).

<sup>45</sup> The SEC estimates that the one-time system changes related to the NBBO disclosure would total approximately \$193 million. NMS Release at 11146-47.

The opt-out is intended to facilitate the flexible use of trading strategies, especially those strategies requiring speed and certainty. Yet, the order-by-order requirement will negatively affect such strategies by slowing down the order handling and execution processes. Requiring those investors who choose to opt out to engage in a rote verbal or on-screen disclosure dialogue would introduce order handling delays that may cripple the intent of the exception. Many of the customers who may be interested in the opt-out will be executing sophisticated investment strategies that require the transmission of many orders in a short period of time or in many related securities simultaneously. We believe that, for the opt-out to be useful, investors should be able to instruct their brokers regarding their decision to opt out for an order in the most efficient manner possible.

SIA also disagrees with the Commissions' concerns about global consent and the corresponding need for order-by-order consent. The SEC and other securities regulators commonly rely on disclosure and global consent to protect investors in any number of areas that are just as critical as the area of price protection.<sup>46</sup> Therefore, we believe that global consent based on adequate disclosure by the broker-dealer is more than sufficient to protect investors from abuse.<sup>47</sup> Under this approach, the broker-dealer could obtain informed consent by requiring the investor to sign an acknowledgment of the proposed disclosures<sup>48</sup> upon opening an account and annually thereafter.<sup>49</sup> Then, the opt-out instruction, without the disclosure step, could be provided either as a default or on an as-needed basis during the order handling process.

Without such a change, implementing the order-by-order requirement would require significant modifications to broker-dealer order handling systems. The SEC estimates that the one-time system changes related to the disclosure for obtaining

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<sup>46</sup> See, e.g., Exchange Act Release No. 42728 (Apr. 28, 2000), 65 Fed. Reg. 25843 (May 4, 2000) (permitting global consent to electronic delivery relating to all documents of any issuer, so long as the consent is informed); Exchange Act Release No. 42101 (Nov. 4, 1999), 64 Fed. Reg. 62539 (Nov. 16, 1999) (discussing household consent rule). See also NASD Notice to Members 00-79 (Nov. 2000) ("after consultation with both the SEC and NASD Regulation, Nasdaq has concluded that firms may use negative consent letters to evidence a customer's request to trade on a net basis, as long as the letter meets [certain] conditions").

<sup>47</sup> At the very minimum, if, as the SEC notes, its concern relates primarily to less sophisticated investors consenting without fully understanding the effect of such consent, then the SEC should permit sophisticated investors, like institutions and professional traders, to opt out on a global basis. See NMS Release at 11139.

<sup>48</sup> NMS Release at 11139.

<sup>49</sup> At least one firm suggests that the Commission should consider the disclosure framework of Rules 11Ac1-5 and 11Ac1-6 under the Exchange Act when fashioning guidelines for brokers to obtain informed consent from customers.

informed consent for the opt-out would total approximately \$83 million.<sup>50</sup> Imposing such tremendous costs on the industry when the same investor protection results can be reached in a far more economical manner would be counter to the goals of the Exchange Act.<sup>51</sup>

## 2. Fast Market Exception

The SEC has proposed to permit a fast market to execute orders within its market without regard to a better price displayed on a slow market, within certain price parameters.<sup>52</sup> We believe that it is imperative that the proposed trade-through rule, if adopted, contain such an exception.<sup>53</sup> We believe, however, that the definition of a fast market should be clarified to ensure that the “fast” designation involves an electronic and immediate computer-to-computer communication, with no human intervention. We also believe that the right of fast markets to trade through a slow market should be absolute, *i.e.*, without regard to price parameters, which are difficult and costly to administer. Instead, the fast market exception should be governed only by the requirements of best execution.

## 3. Other Exceptions

As discussed in more detail above,<sup>54</sup> we also believe that the SEC should include in its proposed trade-through rule certain other specific exceptions. Specifically, we agree with the SEC’s proposed miscellaneous exceptions regarding system malfunctions, non-regular way contracts, unusual markets, openings, re-openings and crossed markets.<sup>55</sup> We also agree with the SEC’s proposed exception for intermarket sweep orders in Proposed Rule 611(b)(7), so long as the exception is clarified as we discussed above.

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<sup>50</sup> NMS Release at 11146-47.

<sup>51</sup> Section 3(f) of the Exchange Act (“[w]henver pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization . . . the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation”); Section 11A(a)(1)(C) (“[i]t is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . economically efficient execution of securities transactions”).

<sup>52</sup> NMS Release, Proposed Rule 611(b)(9).

<sup>53</sup> At least one firm, however, believes that the Commission should not adopt any fast market or quote exception, as such exception inevitably would lead to the SEC setting minimum response time standards, which would impair competition, impede market efficiency, create significant administrative burdens for the SEC, and be unnecessary with the availability of an opt-out exception.

<sup>54</sup> See Section III.B.

<sup>55</sup> NMS Release, Proposed Rules 611(b)(1) - (6).

Finally, in addition to the exceptions proposed by the SEC, we also would recommend a *de minimis* exception as well as exceptions for benchmark trades and large blocks.

#### **IV. Market Access**

##### **A. Linkages**

As discussed above,<sup>56</sup> we believe that efficient access is a critical aspect of today's national market structure. In the existing trading environment, many different trading venues compete for order flow. Yet, currently there are only minimal standards governing the manner of access among the competing market centers. As a result, at times, a broker-dealer may find that a customer's order cannot be routed to the market with the best price, thus decreasing the broker-dealer's ability to obtain quality executions for its customers. Therefore, we believe, as a general market structure matter, that the intermarket linkages should be enhanced to ensure efficient access to the various trading centers. The need for efficient linkages, however, becomes an absolute imperative in an intermarket price protection environment. Compliance with intermarket price protection is impossible without efficient access to the market displaying the best bid or offer.

Given the need for effective linkages, we agree with the goal of the SEC's proposed market access standards, *i.e.*, encouraging fair and efficient intermarket access through private initiatives. Indeed, we believe that, for competitive reasons, market participants will be interested in the most up-to-date technology and routing methods available at any given time, and the proposed standards would permit such technology to evolve on an ongoing basis.

We note, however, that reliance solely on the SEC's proposed market access rules would fail to address access issues related to smaller markets. As the SEC noted in its Supplemental Release, under its proposal, access could remain a problem at relatively inactive ATSS or market makers with little trading volume whose quotations are displayed only in the Alternative Display Facility ("ADF").<sup>57</sup> Market participants could obtain access to such quotations only through direct connections with the particular ATS or market maker. If the SEC obligates market participants to trade with any such market displaying the NBBO by promulgating a trade-through rule, we are concerned about the firms' burden of creating many private linkages to many small ATSS that may charge exorbitant fees for the necessary access. We believe the SEC must resolve this issue in any final rules.

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<sup>56</sup> See Section III.B.

<sup>57</sup> See Supplemental Release at 30146. See also NMS Hearing Transcript at 135, 138-139.

SIA members, however, continue to discuss the best means for addressing this issue. To date, two possible solutions have been proposed. Some members endorse the concept discussed in the Supplemental Release that relatively small markets (e.g., ATSS that have less than 5% volume) should be required by rule to participate in self-regulatory organization (“SRO”) execution systems for their top-of-book. Other members, however, recommend that the SEC mandate that all market centers make their top-of-book available to other market participants via a public intermarket linkage facility. They stress that this proposed intermarket facility is not a central limit order book or so-called CLOB; it is only a limited-purpose intermarket communication facility that provides the means for obtaining access to each market’s top-of-book as required by the proposed trade-through rule. A market participant would be allowed to be part of the NBBO and receive price protection for its best quotes only if those best quotes were accessible through the intermarket linkage.<sup>58</sup> Individual markets that choose to forge private linkages in addition to the public linkage, however, would be free to do so. Given the continued debate over linkages among its members,<sup>59</sup> SIA believes there should be further industry study of connectivity issues.

## **B. Access Fees**

SIA notes that the issue of access fees has been vexing the industry for years. Various SIA constituencies have held strong views both opposing and supporting access fees. Perhaps the only point of agreement in this debate is a desire for resolution of the issue. Therefore, SIA members support the SEC’s effort to develop a market-wide solution to the issue. Given SIA’s diverse membership, however, it is difficult to achieve consensus on the appropriateness of ECN access fees generally.

Some firms believe that access fees that only ECNs are permitted to charge should be eliminated because these fees distort the public quote and decrease price transparency. They believe that ECNs, like other broker-dealers, should be able to charge only those customers with whom they have a contractual relationship and not the other market participants. These firms argue that ECNs should be required to link to the public markets and to do so without the ability to charge fees to access public quotes. These

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<sup>58</sup> The proposed linkage would improve upon the existing ITS Plan by accommodating varied trading systems and markets and by changing the administration of the linkage. Furthermore, the SEC would play an important role in carefully regulating, and providing guidance to, the facility. One reason these firms recommend this option is that, if a broker-dealer is required to obtain access to a market in which it is not a member, then the broker-dealer would not have any recourse if a market does not abide by the rules. In contrast, under the current ITS rules, the broker-dealer has access to the ITS complaint process.

<sup>59</sup> See Letter from Mark Sutton, Chairman, SIA Market Structure Committee, to Jonathan Katz, Secretary, SEC, (May 5, 2000) (SIA comment letter on market fragmentation setting forth requirements for a linkage, including state of the art technology, fair participation standards and a workable governance structure) available at [http://www.sia.com/2000\\_comment\\_letters/pdf/market\\_fragmentation.pdf](http://www.sia.com/2000_comment_letters/pdf/market_fragmentation.pdf).

firms believe that this will encourage true competition and innovation, instead of allowing ECNs to merely subsist on the access fee/rebate structure that currently is in place. Furthermore, these firms believe that the SEC's involvement in setting prices is inherently anti-competitive.

Other firms, however, strongly oppose any attempt by the SEC to eliminate, or establish limits on, access fees, including the SEC's current proposal. They believe that there is no compelling justification for this type of governmental rate-setting. They believe that the proposal interferes with market forces in an arbitrary and harmful manner. These firms dispute the assertion that "non-transparent" access fees distort the public quote. They argue that access fees are no different from similar fees charged by exchanges, commissions charged by broker-dealers, or other transaction-related charges assessed by clearing brokers, settlement facilities and data vendors. These firms also dispute the assertion that permitting ECNs to charge access fees creates an unfair competitive advantage over other market participants; they note that market making firms trading as principal operate under a business model entirely different from an ECN that executes transactions purely on an agency basis. These firms also believe that limiting or prohibiting access fees is unnecessary to resolve outstanding regulatory issues, provided that accessibility issues are resolved and locked and crossed markets are banned.

With this debate as a backdrop, the SEC has proposed a compromise solution. Under the SEC's proposed rule, all quoting market centers, quoting market participants and broker-dealers that display attributable quotes through SROs would be permitted to impose fees for the execution of orders.<sup>60</sup> The access fees, however, would be limited to a *de minimis* amount. Access fees charged by any individual market participant would be capped at \$0.001 per share and the accumulation of these fees would be limited to no more than \$0.002 per share in any transaction. As a threshold matter, we ask the SEC to clarify the definition of an "access fee." We believe that the definition needs to exclude brokerage commissions and also recognize the markets' need to differentiate between members and non-members or subscribers and non-subscribers.

Some firms view the *de minimis* standard as a fair compromise, or at least a good interim measure. These firms believe that it addresses a number of the continuing concerns some firms have expressed about access fees to date. The proposal levels the playing field by allowing various categories of market participants, not just ECNs, to charge an access fee. The proposal also helps to prevent behavior that distorts the market, such as locking markets to receive rebates. In addition, the lowering of access fees is attractive to member firms as a general matter. Finally, by standardizing the fees, the proposal addresses, to some extent, the transparency concerns associated with access fees that are not apparent in an advertised quote.

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<sup>60</sup> NMS Release, Proposed Rule 610(b).

Other SIA firms, however, believe that the SEC's *de minimis* fee solution is inappropriate. In addition to the arguments set forth above about access fees generally, these firms believe that competitive forces, not the SEC, should determine the minimum increment. They believe that there is no compelling justification for rate-setting by the SEC. The SEC has far less intrusive means for addressing its market structure concerns. Indeed, some believe that a combination of market forces, SRO rules and the Regulation NMS proposals regarding linkage standards and locked and crossed markets resolves the underlying fee issues, thereby obviating the need for SEC intervention in this area.

Notwithstanding the many close questions and important issues discussed above, we believe that the SEC should regulate in some fashion access fees associated with quotes that are hit by intermarket sweep orders. Although such regulation could take different forms, we would prefer that the SEC prohibit access fees for only those quotes that are accessed by intermarket sweep orders in order to satisfy intermarket price protection requirements.<sup>61</sup>

### **C. Locked and Crossed Markets**

The SEC has proposed requiring each SRO to promulgate rules that would discourage market participants from engaging in locking and crossing markets, but that tolerate some minimal incidence of locked and crossed markets.<sup>62</sup> We support the SEC's proposed rule to minimize locked and crossed markets, provided that any anti-crossing and anti-locking provisions are limited to situations in which intermarket price protection would be imposed as discussed in Section III.B above. We believe that locked and crossed markets can reflect inefficient pricing, which confuses investors as to the reliability of the quote and creates difficulties for market participants seeking best execution for customer orders.<sup>63</sup> However, unlike crossed markets, locked market

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<sup>61</sup> A number of SIA member firms strongly object to this position. Among other issues, they note that this position effectively would provide firms with the ability to avoid paying access fees simply by marking an order as an intermarket sweep order. It also would deprive firms of the ability to collect a fee when they are displaying an order at the NBBO, which is exactly the point at which their liquidity providing service offers the most value to the market. These firms acknowledge that there is a need to resolve access fee issues in light of a potential trade-through rule for Nasdaq stocks, where such fees are prevalent, and suggest that a more appropriate approach would be to provide limited relief from trade-through obligations with respect to the quotes of market centers charging such fees, combined with guidance that such fees can be considered as a factor by broker-dealers when fulfilling their duty of best execution. At the very least, these firms believe that this issue of "sweep" orders and access fees requires further study in order to achieve the appropriate regulatory result.

<sup>62</sup> NMS Release, Proposed Rule 610(c).

<sup>63</sup> At least one SIA member firm believes that locking and crossing orders provide significant pricing information to the market, that restricting the display of such orders artificially widens spreads, and that there is no basis to the assertion that locked and crossed markets confuse investors. This firm further believes that any supposed difficulties for market participants seeking best execution can be addressed through the less intrusive means of interpretive guidance from the SEC or SROs.

conditions may occur for a wide range of reasons. Therefore, we believe that, when the SROs promulgate such rules, they may need to incorporate certain additional exceptions to their proposed rules for locked markets.

## V. Sub-Penny Quoting

Most SIA member firms believe that quoting in sub-penny increments would not contribute to the maintenance of stable and orderly markets, a primary objective of Congress in mandating the national market system. Although the conversion to decimals brought certain benefits to investors and the markets, member firms believe that the adverse effects of a further reduction in the pricing increment to sub-penny levels would outweigh any additional benefits to be derived. As a result, SIA member firms are in favor of the SEC's proposed ban on sub-penny quoting, subject to the clarifications discussed below.<sup>64</sup>

Member firms are concerned about a variety of adverse effects of sub-penny pricing, including its encouragement of stepping ahead, loss of depth and decreased price clarity. First, member firms believe that sub-penny pricing has a negative impact on certain priority rules that govern which orders are filled first in our securities markets. Member firms continue to believe that traders should be "required to make an economically significant contribution to the price of a security to gain priority over other traders."<sup>65</sup> Sub-penny pricing, however, has been used as a means for stepping ahead of competing limit orders by an economically insignificant amount to gain execution priority, rather than as an expression of trading interest. As a result, stepping ahead may erode investor confidence, particularly when orders remain unexecuted due to executions occurring within sub-pennies of the limit price.

Second, sub-penny pricing increases price points and decrease depth (*i.e.*, the number of shares) available at the best displayed prices, thereby rendering the NBBO less effective in reflecting true trading interest. The decreased depth requires multiple transactions at multiple prices to complete an order, thereby increasing the cost of completing a trade.

Finally, sub-penny pricing increases the incidence of flickering quotes, thereby negatively affecting a broker-dealer's ability to comply with a variety of regulatory

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<sup>64</sup> A minority of SIA member firms believe that competitive forces, not the SEC, should determine the minimum increment. Indeed, some believe that market forces are presently addressing the sub-penny issues without regulatory intervention and, therefore, SEC intervention is unnecessary.

<sup>65</sup> Exchange Act Release No. 44568 (July 18, 2001), 66 Fed. Reg. 38390 (July 24, 2001).

obligations, including the duty of best execution as well as the short selling, locked and crossed, and trade-through restrictions.

SIA believes that the SEC's proposed ban addresses these concerns. Therefore, SIA supports the sub-penny quoting ban as proposed, subject to the clarifications discussed in the following paragraph. SIA supports the application of the ban to all NMS stocks (including ETFs), and agrees with the Commission that the ban should not extend to options. Furthermore, SIA agrees that the ban should not prohibit, under certain circumstances, trades to be executed in sub-penny increments (*i.e.*, those resulting from sub-penny price improvement or from mid-point or volume-weighted pricing systems).

As indicated, we recommend further clarification of two aspects of the sub-penny quoting ban. First, with regard to the low-priced exception proposed by the SEC, member firms believe that the exclusion of securities trading below \$1.00 from the sub-penny quoting ban is appropriate for facilitating executions in those securities. After all, a sub-penny increment represents a greater percentage of the value of a given share of such securities than it does for higher-priced securities. Member firms, however, believe that there should be a limit on the number of decimal places for quotes for the low-priced securities. Most firms suggest that four decimal places should be the cut-off point. In addition, the ban should apply as soon as the security is trading at or above \$1.00, and should not apply as soon as the price of the security drops below \$1.00. In other words, the proposed rule should not require the securities to trade below the \$1.00 level for some specified period of time before the ban is lifted. Second, we request that the SEC clarify that a market participant that has a pattern of guaranteeing sub-penny price improvement would be deemed to be in violation of the prohibition on sub-penny quoting.

## **VI. Market Data**

### **A. Introduction**

SIA continues to emphasize the fundamental importance of timely access to quality data for price discovery and the successful functioning of the U.S. securities markets. Access to market data, and particularly to the NBBO, is an imperative for investors and for the efficient operation of the markets, and an imperative that must be achieved at a price that is fair for all market participants—markets, vendors, broker-dealers and investors, particularly small/retail investors. SIA remains concerned<sup>66</sup> that the Commission's proposals to date, culminating in the NMS Release market data proposals ("Market Data Proposals"),<sup>67</sup> do not achieve economically efficient and widespread access to market data.

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<sup>66</sup> See Letter from Marc Lackritz, President, SIA, to Jonathan Katz, Secretary, SEC (Apr. 11, 2000) available at [http://www.sia.com/2000\\_comment\\_letters/pdf/market\\_info\\_fees.pdf](http://www.sia.com/2000_comment_letters/pdf/market_info_fees.pdf). (SIA comment letter regarding SEC's concept release on the regulation of market information fees and revenues).

<sup>67</sup> NMS Release at 11175-91.

SIA understands that the Commission proposes to address the economic and regulatory distortions related to market data by reworking the revenue allocation formula. We believe this is the wrong focus—the Commission should take this opportunity to address the truly distortive aspects of the current fee regimes, namely that fees have been too high for too long, and are generated via non-transparent processes administered by opaque and anticompetitive governance systems. We believe the only effective way to deal with these issues is to institute a cost-based approach to fees. Such an approach will be enhanced further by a reform of Plan governance systems.

Specifically, SIA member firms believe that the SEC should require the various Plan participants to institute a direct cost-based system (subject to an effective audit) for determining the level of market data fees to be charged. In conjunction with this direct cost-based system, the Commission should adopt changes that would require more transparent fee setting, along with open and participative governance structures. The effect of these efforts would, we believe, lower market data fees by subjecting fee levels and fee-setting processes to public scrutiny. In any event, we believe that, by not proceeding in such a manner but instead focusing entirely on a reworked allocation formula, the Commission has simply created a more elaborate system for perpetuating existing, serious problems.

SIA believes that before the Commission determines how market data revenues should be allocated, it first must address the key regulatory question that has remained open for many years now:<sup>68</sup> whether the present utilization of market data fees to cover regulatory and other costs in addition to the costs of gathering and disseminating market data is consistent with the statutory purpose.<sup>69</sup> Because market participants must have access to market data for both trading and regulatory purposes,<sup>70</sup> the Commission is charged by statute with assuring that access to this information is available on terms that are “fair and reasonable” and “not unreasonably discriminatory.” Therefore, we believe that market data fees should be used solely to cover the costs of collecting and disseminating market data. Limiting market data fees in this way would, we believe, eliminate those serious economic and regulatory distortions the Commission’s proposals

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<sup>68</sup> See Regulation of Market Information Fees and Revenues, Exchange Act Release No. 42208 (Dec. 9, 1999), 64 Fed. Reg. 70613 (Dec. 17, 1999); Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change (Sept. 14, 2001) *available at* <http://www.sec.gov/divisions/marketreg//marketinfo/finalreport.htm>.

<sup>69</sup> Section 11A of the Exchange Act.

<sup>70</sup> Access to the NBBO and market data generally is necessary for compliance with many regulations, such as best execution, short sale requirements, and the trade-through rule.

seek to address, and would provide a more direct way to address these concerns than a reworked revenue allocation formula.<sup>71</sup>

Correspondingly, we believe that the Commission should not utilize market data fees for other purposes.<sup>72</sup> If the NBBO is a “utility,” and the Commission is clearly affording it a central position within the Market Data Proposals, we believe that its use by the SROs as a generator of profits and its role within the Market Data Proposals as an incentive for certain types of trading behavior and market structures are inappropriate.

We also believe that it is inappropriate to use market data fees as camouflage for regulatory fees. We believe that regulatory fees—separately charged and transparently accounted for—should pay for regulatory costs. SIA recognizes the SROs’ claim that market data fees are currently used to underwrite the costs of market regulation. Although we would like to see that claim supported (especially in light of various rebate programs and other recent revelations), SIA is not, in any way, advocating cuts to or the underfunding of regulation. SIA, in fact, strongly advocates vigorous and well-funded self-regulation because such regulation is essential to both investor protection and investor confidence. SIA believes that a transparent, cost-based fee structure for market data in no way will undermine the funding for regulation. Transparent accounting for regulatory costs and fees only will enhance the funding of regulation by clarifying those regulatory costs that must be met.

In other words, SIA believes that market data fees, and the debate surrounding them, do not belong in any discussion of regulatory funding. We understand that the Commission is contemplating the issuance of a release on the structure of self-regulation, which may include a review of how best to ensure the adequacy of regulatory funding. We believe that the debate over market data fees should occur in the context of this NMS Release, while the debate over how best to fund regulation in the most transparent and accountable manner should occur in the context of the anticipated self-regulation release. The cost of market data is and should remain an entirely separate issue from the question of how an SRO funds its regulatory costs.

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<sup>71</sup> While SIA believes the only truly effective approach to market data fee reform is a reexamination of the reasonableness of current fees and the institution of cost-based calculations, paired with an overhaul of Plan governance structures and methods, to the extent the Commission elects to revise the allocation formula, SIA supports a revision of the allocation formula that ensures only firm and accessible quotes are considered when allocating revenues. Were manual quotes to be so excluded, SIA also would support the elimination of the “NBBO Improvement Share” element of the allocation formula.

<sup>72</sup> Congress saw the statutory scheme (Section 11A) as “granting the Commission broad authority to oversee the implementation, operation, and regulation of the national market system.” See Report of the Committee on Banking, Housing and Urban Affairs To Accompany S. 249: Securities Acts Amendments of 1975, S. Rep. No. 94-75, at 8-9 (1975).

SIA believes that Commission review and action related to market data should center on the underlying rationale for, and levels of, market data fees in order to determine whether the reasons why they are collected, the level at which they are set, and the ways in which they are spent are fair, reasonable and not unreasonably discriminatory.<sup>73</sup> Making these determinations also will allow market participants to understand more clearly whether market data fees are meeting costs beyond those related to gathering market data. To those ends, we believe that:

- (i) Current and future fees should be accounted for transparently, and supported by independent audits of the Networks and annual filings that cover expenses, revenues, and projections;
- (ii) Fees should be set and changed through a collective process that involves market participants, operates transparently and permits real challenge. The current SEC rule filing process does not have these characteristics and inappropriately allows for fee changes through the “effective upon filing” or “pilot” procedures;
- (iii) Fees should be limited to the cost of collecting and disseminating market data, thereby rendering rebates redundant;
- (iv) The Networks’ contractual and usage requirements should be reduced, streamlined and uniform, which will assist in lowering fees and associated administrative burdens;
- (v) Plan governance also should be transparent, with any advisory committee structured to reflect industry and investor involvement and empowered beyond the merely cosmetic;
- (vi) Information should be channeled through a single securities information processor (“SIP”);<sup>74</sup>
- (vii) Any fees chargeable for non-core data such as depth-of-book should be subject to market forces;<sup>75</sup> and

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<sup>73</sup> SIA is not, in this letter, addressing substantively the question of proprietary interests in market data, and the Commission should state in any adopting release that it is not addressing that issue either. For data ownership to be addressed, the Commission would need to solicit specific public comment.

<sup>74</sup> At least one firm is concerned about the implications of industry reliance on one SIP (such as the consequent risks inherent in a single point of failure and the establishment of a potential monopoly with no incentive to innovate). Should the Commission adopt the consensus position advocating a single SIP, this firm believes that these potential risks should be monitored on an ongoing basis and that, if warranted, there should be further exploration of the need for multiple SIPs.

(viii) Market data provisions, including definitions and applications of fee categories such as “professional” and “non-professional” and limitations on the redistribution of data, should be the subject of a fresh review and uniform rulemaking.

## **B. Unnecessary Costs to Investors**

SIA believes that current fees are substantially in excess of the costs of collecting and disseminating market data. The SEC notes in the Market Data Proposals that fees charged by the Networks for 2003 resulted in net income of \$386,027,000, while Network expenses totaled \$38,300,000.<sup>76</sup> This represents a 1000% mark-up for fees charged compared to actual Network costs of collection and dissemination at a time when efficiencies in connectivity should be reducing the base costs for all involved.<sup>77</sup> Indeed, the very existence of rebates demonstrates the excessive level of current fees—rebates are a competitive response of a service that has out-priced itself. Rebates also encourage conflicts of interest, significant distortions in market place behaviors, and regulatory arbitrage. A rationally and clearly priced market data system, free of rebates, is an appropriate foundation for the national market system.

SIA believes that there are a number of factors that directly contribute to excessive fee charging. Market data costs are not transparent enough to allow a proper assessment of the appropriateness of fees charged, in large part because the SROs’ operating costs and how they use the fee revenues are not revealed. Further, the data made available to support the Networks’ fee increases is insufficient, and insufficiently transparent. Comments made by the SROs at the NMS Hearing emphasized the lack of transparency in the fee charging process.<sup>78</sup>

SIA believes that the accounting, auditing and reporting of market data usage should be processes that allow for meaningful participation by data producers and users.

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<sup>75</sup> The SIA believes, however, that the Commission should undertake a study of the impact of different levels of transparency among market participants (e.g., between retail and institutional investors) in this era of decimalization where depth of book data is not readily available to all.

<sup>76</sup> NMS Release at 11179.

<sup>77</sup> Robert Griefeld of Nasdaq noted the following at the NMS Hearing: “Currently . . . [the] cost for professional investors [to access market data] is around \$20. That cost in a NASDAQ market was established by NASDAQ over 20 years ago. It was about \$17 twenty years ago. There was no great wisdom in that number, and [when] we look at the number today, that number is too high. We agree with that concept. The number probably should be somewhere around five to seven dollars.” See NMS Hearing Transcript at 223-24.

<sup>78</sup> See id.

SIA also continues to support the idea of annual filings for the Networks, setting out fees, user information and audited financial statements. In addition, full disclosure of the volume projections on which the SROs base their pricing proposals, along with impact analyses for the various categories of data-user, should be required. Subsequently, the actual volume when compared with the initial projections should be disclosed, in order to achieve full transparency of the costs of market data collection and dissemination.

### **C. Opaque Plan Governance**

SIA believes that transparent and open Plan governance structures would assist in the elimination of those economic and regulatory distortions the Commission has identified, particularly when implemented in conjunction with a cost-based fee levy. The Commission effectively has delegated rate-making to the SROs; therefore, it is even more important that Plan governance not only be transparent, rigorous and independent, but also follow those principles of sound corporate governance the Commission requires of the SROs. The administration of the NBBO should not be the province of parochial interests operating behind closed doors.

Existing Plan governance structures, however, allow rate setting by self-interested parties, who are constrained to unanimity only in the case of a proposed reduction in fees. While SIA supports the Market Data Proposals insofar as they suggest securing wider industry and investor involvement in Plan governance, a non-voting advisory committee, as suggested in the Market Data Proposals, will not have the power to make inroads into issues of excessive fee charging. This requires an independent advisory committee or an equivalent, with sufficient powers to ensure that decisions are made and implemented subject to appropriate checks and balances.

Existing regulatory provisions that permit changes in fees charged by the Networks to become effective upon filing with the SEC allow for only perfunctory review and comment on such revisions. The fact that the Commission may abrogate the proposal and require refiling does not equate to a substantive review or challenge to the fees charged, and has not proved such in the past. We believe that market data fee proposals should be described in SEC filings in a manner akin to the obligation imposed upon the Commission to publish projections on which it bases fees recovered under Section 31 of the Exchange Act. As they stand, the Market Data Proposals do not facilitate informed and meaningful public and industry participation and comment when fee proposals are filed with the Commission.<sup>79</sup>

A combination of the above inefficient factors produced the current costly and unwieldy fee structure. The Networks appear to have capitalized on the rapid changes in the level and type of market data use in recent years, rather than expend efforts to reduce

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<sup>79</sup> Recently, the SEC has emphasized its concern with incompletely justified SRO rule filings. See Exchange Act Release No. 49505 (Mar. 30, 2004), 69 Fed. Reg. 17863 (Apr. 5, 2004).

overall fees to reflect increased efficiencies in the market data systems. For example, charges are pegged to the method by which an investor accesses the data (through a representative, through an automated phone system, or over the Web). This fee method discriminates against investors using firms that offer multiple channels of access or simultaneous access by charging duplicative fees. Similarly, the use of “step fees,” whereby charges are pegged to the number of stand-alone interrogation devices used by the subscriber, discriminates against smaller firms. Also, the SROs’ use of MISU, or multiple instance single user fees, poses a substantial and unnecessary administrative burden on users.

In addition, much of the higher fees are generated through inconsistent and expansive interpretations of the “professional” definition under which firms and their clients pay higher fees for the same market data. For example, the Networks have applied that definition to anyone who accessed market data through an account that is in a non-natural person’s name, regardless of whether that person is linked in any way to the securities industry. The distinction is critical. A case in point is Network B for Amex-listed securities, which has no per quote fee schedule for professionals. Thus, if an investor meets the definition of professional, he or she must pay a flat rate of \$27.25 per month, even if that investor accesses only a single quote online that month. We believe that improving the structure under which fees are set will encourage more rational approaches to market data fees.

#### **D. Excessive Administrative Burdens**

Presently, users of market data are required to enter into heavily papered relationships with the Networks in order to receive that data. SIA believes that the lack of consistency among the Networks as to their requirements for these relationships, from inception to billing, goes beyond what could be considered ordinary differences between the practices of individual businesses operating within the same industry sector. SIA further believes that these inconsistencies and burdensome requirements directly contribute to the present, unacceptably high level of fees charged for market data.

Agreements. Firms are required to enter into vendor agreements, subscriber agreements and customer agreements,<sup>80</sup> as well as to provide exhaustive and complex technical descriptions of their market data operations (including proprietary information) and the manner in which the data will be utilized by the end-user. Investors are required to subscribe to unduly confusing “quote subscriber” agreements before being able to access quotes. These significant administrative burdens are compounded by inconsistent

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<sup>80</sup> Broker-dealers distributing material externally to customers are required to contract with the exchanges as both vendors and subscribers.

Network requirements across these agreements. Standardization and streamlining of market data terms, conditions, policies and procedures into a uniform, concise and consolidated contract would significantly reduce vendor and subscriber costs. Accordingly, we recommend that the Commission require the Networks to work together to propose and then issue one uniform agreement, subject to public notice and comment.<sup>81</sup>

Data Use Policy. Policies on data use and distribution, quote counting and reporting requirements, and documentation and reporting of data usage differ across the SROs. These policies and related administrative requirements are frequently unilaterally changed by the Networks, with no notice or consultation. As the recent Commission order in the Bloomberg action<sup>82</sup> demonstrates, policies that affect the display and distribution of market data have the force of rules and should be subject to public rulemaking procedures. There is also disparity between the Networks as to the types of internal and external devices actually subject to market data fees, requiring firms to further adapt their systems to capture quote data usage. We believe that such data use policies should be streamlined and made uniform.

Billing and Fee Collection. The Networks also employ differing methods of billing and fee collection. SIA believes that a uniform system for the billing and collection of quarterly, semi-annual or annual fees would not only significantly ease administrative burdens, but also assist in fee reduction.

Annual Audits. Firms are further subject to time-consuming and unduly burdensome annual audits by the Networks, which can include inappropriate requirements to divulge customer information. Such audits should be focused and streamlined wherever possible.

Multiple SIPs. The above inefficiencies are compounded by multiple SIPs. SIA can see no justification for the continued use of multiple SIPs for market data. A single, consolidated SIP would result in considerable cost and time savings at no risk to the investor.

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<sup>81</sup> A good example of such standardization and streamlining exists in the futures market, where the futures exchanges have consolidated their agreements into a single agreement executed by the end user.

<sup>82</sup> See Exchange Act Release No. 47891 (May 20, 2003).

Jonathan G. Katz

June 30, 2004

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The SIA appreciates this opportunity to address the many issues raised by the NMS Release. We look forward to working with the members of the Commission and its staff to enhance the U.S. market structure in the months ahead. If you have any questions concerning these comments, or would like to discuss our comments further, please feel free to contact me at 202-216-2000, Don Kittell, Executive Vice President, at 212-608-1500, or Ann Vlcek, Vice President and Associate General Counsel, at 202-216-2000.

Sincerely,

Marc Lackritz  
President

cc: Chairman William H. Donaldson  
Commissioner Paul S. Atkins  
Commissioner Roel C. Campos  
Commissioner Cynthia A. Glassman  
Commissioner Harvey J. Goldschmid  
Annette Nazareth, Director, Division of Market Regulation  
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