

Financial Services

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SEC Proposes Regulation NMS

On April 21, 2004, the Securities Exchange Commission (the “Commission” or “SEC”) held a hearing on proposed Regulation NMS¹, which is intended to enhance and modernize the regulatory structure of the U.S. equity markets. In addition to redesignating the existing national market system (“NMS”) rules adopted under Section 11A of the Securities Exchange Act of 1934 (“Exchange Act”), Regulation NMS would incorporate four substantive proposals: (1) a rule that would require all national securities exchanges, national securities associations and order execution facilities (collectively, “NMS market centers”) to establish, maintain and enforce policies reasonably designed to prevent the execution of orders at a price that is inferior to a price displayed in an order execution facility (“Trade-Through Proposal”); (2) a market access rule intended to improve the terms of access to quotations and execution of orders in the NMS (“Market Access Proposal”) (3) a rule prohibiting market participants from accepting, ranking, or displaying orders, quotes or indications of interest in a pricing increment smaller than a penny (“Sub-Penny Pricing Proposal”); and (4) amendments to rules governing the dissemination of market information to the public (“Market Data Proposal”). Regulation NMS represents a significant step in the SEC’s ongoing review of U.S. equity market structure.

The SEC expressed three main objectives in the release proposing Regulation NMS (“Proposing Release”): (1) promote equal regulation of market centers; (2) update antiquated rules that no longer reflect current market conditions; and (3) promote greater order interaction and displayed depth. As the Proposing Release states, “The NMS needs to be enhanced and modernized, not because it has failed investors, but because it has been so successful in promoting growth, efficiency, innovation and competition that many of its old rules are now outdated.”

On May 20, 2004, the SEC extended the comment period on Regulation NMS to June 30, 2004 and published a supplemental request for comment to give the public an opportunity to comment on a number of issues discussed during the hearing.²

This Financial Services Update discusses the recent hearing and summarizes the rule proposals incorporated in Regulation NMS.³

¹ *Proposed Rule: Regulation NMS*, Rel. No. 34-49325 (Feb. 26, 2004) (“Proposing Release”).

² *Proposed Rule: Regulation NMS*, Extension of Comment Period and Supplemental Request for Comment, Release No. 34-49749 <http://www.sec.gov/rules/proposed/34-49749.htm>.

³ More information about Proposed Regulation NMS is available at <http://www.sec.gov/spotlight/regnms.htm>.

Regulation NMS Hearing and Supplemental Request for Comment

The purpose of the hearing was to elicit public comment from various securities industry participants on both the perceived impact of proposed Regulation NMS on the marketplace in general and specific aspects of the proposal. The hearing consisted of a series of seven subject matter panels, with three panels devoted to aspects of the Trade-Through Proposal, two panels devoted to the Market Access Proposal, one panel devoted to the Sub-Penny Pricing Proposal and one panel devoted to the Market Data Proposal. The participants on each panel often represented competing industry participants on both the sell and the buy side, resulting at times in divergent viewpoints on the benefits of certain aspects of proposed Regulation NMS. Recognizing this dynamic, SEC Chairman Donaldson in his opening remarks noted that Regulation NMS is intended to advance the discussion of modernizing and improving the U.S. equity markets and that the SEC has not made any final decisions with respect to any of the specific proposals set forth in Regulation NMS. He requested that participants on the subject panels put aside their own institutional interests and focus on how the proposals and alternatives to the proposals will serve the U.S. equity markets and the investing public from a public policy perspective.

An overview of the key points raised during the hearing and for which the SEC is seeking additional public comment follows the summary of Regulation NMS's four specific proposals.

Trade-Through Proposal

Section 11A of the Exchange Act, enacted as part of the Securities Acts Amendments of 1975, directs the SEC to "facilitate the development" of an NMS that reflects the principles set forth by Congress, including:

- assuring economically efficient execution of securities transactions;
- assuring fair competition among brokers and dealers, among exchanges markets, and between

exchange markets and markets other than exchange markets;

- assuring the availability to brokers, dealers and investors of information with respect to quotations for and transactions in securities;
- assuring the practicability of brokers executing investors' orders in the best market; and
- assuring the opportunity for investors' orders to be executed without the participation of a dealer (to the extent that this principle is consistent with the first and fourth principles).⁴

According to the Proposing Release, the SEC "believes that its central role is to facilitate the development of an NMS, not to dictate the precise form that the NMS will take." However, the SEC states that one of the "most important" goals of an NMS is the "encouragement of the display of limit orders and aggressive quotes, which provide the basis for all price discovery in the markets."

In 1979, the SEC approved a plan to link the market centers trading exchange-traded securities (the "ITS Plan"). After much study and discussion, in 1981, the SEC approved amendments to the ITS Plan that prohibited certain market participants from executing orders at a price worse than the best price displayed by another participant market in the public quote. In the late 1990s, the Commission adopted rules under the Exchange Act requiring certain exchange specialists and over-the-counter ("OTC") market makers to publicly display customer limit orders that better the specialist's or market maker's displayed price and/or size. At the same time, the Commission amended Rule 11Ac1-1 (the "Quote Rule") to require a specialist or OTC market maker to publicly display its best-priced quotations and customer limit orders for any listed security when it is responsible for more than 1% of the aggregate trading volume for that security. All national securities exchanges and the NASD are now members of the ITS Plan, which requires each member to provide other Plan participants with electronic access to its displayed best

⁴ Section 11A(a)(1)(C) of the Exchange Act.

bid or offer and provides an automated mechanism for routing orders to reach those displayed prices.⁵

Under the current regime, the ITS trade-through rule requires members of an exchange, when purchasing or selling a security traded through ITS on the exchange or by issuing a commitment to trade⁶ through ITS, to avoid initiating a trade-through.⁷ The current trade-through rules apply to exchange members and registered OTC market makers who trade securities listed on the New York Stock Exchange (“NYSE”) or American Stock Exchange (“Amex”), but not to block positioners that operate in the OTC market without registration as OTC market makers. Additionally, the trade-through rules do not apply to alternative trading systems (“ATs”) that trade NYSE- or Amex-listed securities in the OTC market, unless they are required to post quotes in the consolidated quotations system through a self-regulatory organization (“SRO”). Currently, there are no intermarket trade-through rules with respect to the trading of Nasdaq securities.

One drawback of the current rule is that it effectively prevents a market center from executing an investor’s order immediately and at an inferior price, even if the investor would prefer speed or price certainty to a better price displayed in another market. The Proposing Release notes that the “challenge of providing price protection across these diverse markets has grown”

⁵ Only the International Securities Exchange is not a member; however, this exchange trades only securities not covered by the ITS Plan.

⁶ Pursuant to the ITS Plan and SRO trade-through rules, an ITS Participant can send a commitment to trade (a firm obligation to trade for a fixed period of time (usually 30 seconds or one or two minutes)) to another ITS Participant to trade with a better price displayed by that other Participant market. If the receiving ITS Participant accepts the commitment to trade, the system reports back an execution to the sending ITS Participant. If the commitment to trade is not accepted by the receiving ITS Participant within the specified time frame, the commitment is automatically canceled.

⁷ The ITS rule defines a trade-through to occur when a member initiates a purchase (sale) on the exchange of a security traded through ITS at a price higher (lower) than the price at which the security is offered (bid for) at the time of the purchase (or sale) in another ITS participant market as reflected in the offer (bid) then being displayed on the exchange from the other participant market.

because “competing market centers currently offer different speeds and levels of certainty of execution.” An additional problem is that not all market participants affected by the operation of the trade-through rules have a direct voice in the administration of the ITS Plan.

Trade-Through Proposal

The Trade-Through Proposal would require “order execution facilities,”⁸ national securities exchanges and national securities associations to establish, maintain and enforce policies and procedures reasonably designed to prevent the purchase or sale of an NMS Stock⁹ at a price that is inferior to a better price displayed in another market. Under proposed Rule 600, “trade-through” would be defined as the purchase or sale of an NMS Stock during regular trading hours, either as principal or agent, at a price that is lower than the best bid or higher than the best offer of any order execution facility that is disseminated pursuant to an effective NMS plan at the time the transaction is executed. The Proposing Release states that the SEC does not believe that including non-quoting markets in the definition of order execution facility will create a hardship for these markets, but is seeking comment on this issue. The Trade-Through Proposal would not apply to limit orders or quotes that are not disseminated pursuant to an NMS plan, and it only would apply to the best bid or best offer for each market. The SEC recognizes that extending the protection any further would require markets to provide access to their entire depth of book to other markets and, while the SEC believes that this may be an admirable goal, it is not likely to be feasible.

While the Trade-Through Proposal would require the establishment, maintenance and enforcement of policies and procedures reasonably designed to prevent trade-

⁸ Under the Trade-Through Proposal, an “order execution facility” would be broadly defined to include all national securities exchanges and national securities associations that operate a facility that executes orders, ATs, 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.

⁹ NMS Stocks include NYSE, Amex and Nasdaq stocks.

throughs, the Trade-Through Proposal does not mandate the exact content of such policies and procedures. However, the Proposing Release does state that, among other things, the policies and procedures should provide for the “monitoring of quotations in other markets” and prevent “a trade from being effected in its market at a price inferior to a bid or offer that was apparent to the order execution facility in another market.” The Proposing Release also suggests that order execution facilities should have processes for identifying “false positive” and “false negative” trade-throughs. The SEC is seeking comment on specific procedures that could be implemented to prevent and identify false positive and false negative trade-throughs.

As a complement to the trade-through restrictions, Regulation NMS also includes provisions to improve access to prices in other markets, discussed in more detail below.

Exceptions to the Trade-Through Proposal

Recognizing that investors may value speed and/or certainty of execution over the possibility of obtaining a better price in another market, the SEC is proposing two major exceptions to the Trade-Through Proposal: (1) the opt-out exception and (2) the automated market exception.¹⁰ Under the opt-out exception, customers, as

¹⁰ The Commission also is proposing a third exception from the trade through rule:

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

well as broker-dealers trading for their own accounts, would be able to opt out of the protections of the rule by providing informed consent on an order-by-order basis, based on their execution preference at the time of placing an order. The opt-out exception would allow the customer’s order to be executed in one market without regard to the possibility of obtaining a better price in another market. While the Trade-Through Proposal would not mandate the method used by the broker-dealer to obtain informed consent from each customer, the Proposing Release states that, at a minimum, a broker-dealer should explain that:

- the customer’s order would be executed in the market to which it is sent without regard to prices displayed in other markets, even if those prices are better;
- the customer affirmatively would be agreeing to forego the possibility of obtaining a better price that may be available in another market at the time its order is executed; and
- this could result in the customer’s order receiving an execution at a price that is inferior to the best bid or offer displayed at the time his or her order is executed.

For those customers who choose to opt out, the broker-dealer would be required to disclose the national best bid or offer (“NBBO”) at the time of execution for each execution where a customer opted out. This information would need to be disclosed to customers as soon as possible, but in no event later than one month from the date the order was executed. According to the Proposing Release, the requirement is intended to “help ensure that customers who opt out of the proposed rule’s protections are informed of the consequences of opting out, and are

executed against Market B’s better-priced bid or offer, the broker-dealer executing the inferior-priced order, or the broker-dealer on whose behalf the order is being executed, still must fulfill its duty of best execution to its customer with regard to that order, by providing the customer order the better price.

Proposing Release, *supra* note 1 at text accompanying n. 82. The proposal would include other minor exceptions.

able to compare the execution they received to the best displayed bid or offer at the time of execution.”

The Proposing Release does note that the opt-out provision is inconsistent with the notion of price protection for limit orders, which the SEC has long identified as an objective of the NMS. However, under the Trade-Through Proposal, broker-dealers would not be required to permit customers to opt out.

Additionally, the SEC is seeking comment on whether the ability to opt out should be limited to institutional or sophisticated investors “who may be better qualified, or in a better position to understand the implications of opting out than retail investors.”

The SEC also proposes, as an additional exception, an automated execution alternative. This proposed automated execution exception would permit an “automated market” to execute orders within its market without regard to a marginally better price displayed on a “non-automated market.” Under this proposal, there would be two types of order execution facilities:

- “automated order execution facilities,” which would be defined as facilities that provide “for an immediate response to all incoming orders for up to the full size of its best bid or offer disseminated pursuant to an effective national market system plan, without any restrictions on executions”; and
- “non-automated order execution facilities,” which would encompass those facilities not qualified as automated order execution facilities.

The automated order execution facilities would exclude market centers that turn off their automatic execution systems or otherwise limit the ability to access their quotes or orders on an automated basis. The SEC is seeking comment on these definitions and whether there should be restrictions that a market center could impose and still be considered an automated order execution facility. Additionally, the SEC is requesting comment on who should have responsibility for determining which market centers qualify as automated order execution facilities—the SEC, a third party, or the individual market centers.

Under the proposed automated execution exception, automated order execution facilities would be able to trade through the price on a non-automated order execution facility that is marginally superior to the execution price on the automated facility, but would not be able to trade through prices of other automated order execution facilities. The SEC proposes that this marginal amount, the “trade-through limit amount”, should reflect the cost of attempting to access a better price in a non-automated market.¹¹ According to the Proposing Release, the SEC believes

that the amount by which an automated order execution facility should be allowed to trade through a non-automated order execution facility should relate, to the greatest extent possible, to the value of the option that must be given to the other market when attempting to access the better price.

The Proposing Release suggests that this automated execution alternative addresses “two of the potential serious flaws” of the opt-out proposal. First, the automated execution alternative is consistent with the principle of price protection for limit orders. Second, the SEC believes that this alternative supports the principle of price priority, as it would not allow trades to occur at inferior prices, which could happen under the opt-out exception. The SEC is seeking comment on whether the opt-out exception would be necessary if the automated execution alternative is adopted.

Regulation NMS Hearing Comments

The first of the three panels discussing the Trade-Through Proposal consisted of representatives of the NYSE, the Nasdaq Stock Market (“Nasdaq”), an electronic communications network (“ECN”), large

¹¹ The SEC is proposing the following “trade-through limit amounts”: (1) one cent for bids or offers up to \$10; (2) two cents for bids or offers between \$10.01 and \$30; (3) three cents for bids or offers between \$30.01 and \$50; (4) four cents for bids or offers between \$50.01 and \$100; and (5) five cents for bids or offers over \$100. The SEC is seeking comment on the utility of this approach and the reasonableness of these proposed trade-through limit amounts.

financial services firms and the Securities Industry Association. The panel was asked to discuss the need for and perceived benefits of an inter-market trade-through rule and an opt-out exception. A majority of the panelists supported the Trade-Through Proposal but disagreed on the need for and scope of the opt-out exception. Notably, John Thain, CEO of the NYSE, believed that the Trade-Through Proposal provides an important protection to market participants by assuring receipt of the best price available in the marketplace. He was concerned, however, that the proposed opt-out exception was overly broad and may result in a more fragmented marketplace due to increasing internal execution by exchanges of order flow from investors who exercise opt-out rights. On the other hand, Robert Greifeld, President and CEO of Nasdaq, strongly favored the opt-out exception on the basis that it provides market participants with the opportunity to seek best overall execution, taking into account factors in addition to receipt of the best price available, including speed and certainty of execution, price impact, commission cost and other factors. The other panelists generally supported one position or the other, but the general consensus was that a combination of a trade-through requirement and opt-out exception was appropriate in light of current marketplace practices and conditions. Some members of the panel espoused the view that the opt-out exception would become less relevant over time as traditional auction markets begin offering automated order execution facilities to market participants.

The second panel, consisting of representatives of the Chicago Stock Exchange, another ECN, financial institutions and broker-dealers including floor brokers on the NYSE, was also generally supportive of the Trade Through Proposal. Picking up where the first panel left off, the panelists discussed the perceived impact of the trade-through rule and its exceptions including, in particular, the automated market exception. Many panel members expressed concern over defining “automated markets” based upon a market center’s ability to provide an execution within a specific period of time (referred to as “fast markets” or “slow markets”). One suggestion that received some support was that “automated markets” should be determined by reference to a market participant’s ability to obtain an immediate automated response that an order was either executed (in whole or

in part) or that it could not be executed because a prior incoming order has been executed against the quotation or for another reason. One alternative that was discussed was to make the exception applicable to manual quotes that are not immediately accessible through an automatic execution facility instead of providing an overall exception for manual markets. Panelists noted current technology permits order routing facilities to distinguish between manual and automated quotes so that all market participants could choose between the benefits of automatic execution or auction execution on a traditional trading floor. Several panelists also held the opinion that the relevance of the automated market and opt-out exceptions to the trade through rule would decline as market centers become more automated.

The third panel focused on the feasibility and challenges of combining an auction style market and its potential for improved price and liquidity beyond the market’s displayed quotes and an automatic execution facility which provides for the fast execution of displayed quotes. The panel consisted of representatives of various exchanges, including NYSE, Amex and Chicago Board Options Exchange (“CBOE”) and their member firms. John Thain and Salvatore Sodano, Chairman and CEO of the Amex, confirmed their respective exchange’s commitments to adopting a hybrid order execution model along the lines of the system adopted by the CBOE. The hybrid systems will permit customers of the exchanges or the floor brokers executing customer orders to choose to direct all or a portion of an order to an automatic execution system or to a broker or specialist for execution on the exchange floor for execution in the auction market. While recognizing that automatic execution provides certain benefits to investors (such as speed of execution), both Messrs. Thane and Sodano expressed strong support of the benefits of the auction market system, including its ability to provide price discovery and to lower intra-day trading volatility. The NYSE and Amex are in discussions with SEC staff regarding the development of rules for the use of their respective hybrid systems. NYSE’s hybrid system, known as “Direct +”, is currently in operation for small orders of up to 1,099 shares and is expected to be enhanced to accommodate larger orders in a matter of months. Amex’s hybrid system is expected to be operational by the fourth quarter of 2004. Neither the

NYSE nor Amex expect difficulties implementing their respective hybrid systems with respect to the Trade-Through Proposal.

SEC Request for Additional Public Comments

In light of the possibility that quotations in the NMS may become predominantly accessible through automatic execution systems as a result of the integration of automatic execution and traditional auction trading facilities by exchanges, the SEC is seeking public comment on the likely effect such a change would have on the proposals contained in Regulation NMS. A number of the Regulation NMS proposals (such as trade throughs, market access and market data) derive from the need to accommodate both automatic execution and manual quotations within the NMS. In particular, the SEC is seeking comment whether the exception to the trade through rule should apply on a quote by quote basis (i.e., to manual quotes or quotes not accessible through an automatic execution facility) as opposed to providing an overall exception for a manual market and, to the extent that trade throughs of manual quotes are permitted, the amount by which the market should be able to trade through a manual quote. The SEC is further requesting comments on how manual quotes can best be identified in the consolidated stream so that market participants can identify quotes subject to execution by manual market centers. In connection with the panel discussions regarding the requirements of an “automated order execution facility,” the SEC is seeking comment on whether such facilities must be able to provide an immediate response reporting whether an order was executed (in whole or in part) or cancelled. Comments are also solicited on whether market centers should be held to specific performance standards with respect to reporting the execution or cancellation of an order and for updating posted quotes within the NMS. Finally, the SEC is requesting public comment as to whether there is a need to provide a general opt out right in light of anticipated automation by traditional auction markets, especially if the SEC were to permit trade throughs of manual quotes.

Market Access Proposal

The Market Access Proposal, Proposed Rule 610 of Regulation NMS, would require market centers to permit all market participants access to their limit order books, at least indirectly, on a non-discriminatory basis. The Proposing Release suggests that “ensuring access to diverse marketplaces within a unified national market would foster efficiency, enhance competition, and contribute to the ‘best execution’ of orders for securities.” Under the Market Access Proposal, quoting market centers¹² and quoting market participants¹³ would not be permitted to impose discriminatory terms that inhibit non-members, non-subscribers or non-customers from obtaining access to quotations and the execution of orders through their members, subscribers or customers. Additionally, quoting market participants would be required to make their quotations available to all quoting market centers and other quoting market participants on terms as favorable as those they grant to preferred members, subscribers or customers. The proposed market access rule would not establish government imposed linkages between markets, but rather would rely on those linkages established by the marketplace.

According to the Proposing Release, the SEC believes this proposal is necessary because access fees, while decreasing in recent years, are “currently causing various distortions in the trading of securities.” The Proposing Release notes that ECNs in particular impose per-share access fees and these fees have exacerbated so-called “locked” markets.¹⁴ The SEC considered four

¹² A “quoting market center” would be an order execution facility of any exchange or association that is required to make available to a quotation vendor its best bid or best offer in a security pursuant to Rule 11Ac1-1 under the Exchange Act (the “Quote Rule”).

¹³ A “quoting market participant” would mean any broker-dealer that provides its best bid or offer in a security to an exchange or association pursuant to the Quote Rule or Regulation ATS, and whose best bid or best offer is not otherwise available through a quoting market center.

¹⁴ A locked market occurs when an offer to sell at a certain price is displayed on one market at the same price as an offer to buy on another market, but the orders cannot meet because the markets are not linked. The Proposing Release suggests that anecdotal evidence indicates increases in locked markets. See Proposing Release, *supra* n.1 at nn. 150-151.

alternatives before settling on a proposed *de minimis* fee standard:

- *Requirement that access fees be accurately reflected in displayed quotes of market participants.* The SEC dismissed this alternative because, as currently imposed, access fees amount to less than one cent, which would require sub-penny quotes.¹⁵ The SEC believes that increased use of sub-penny pricing would reduce the depth of liquidity available to investors at each particular sub-penny price and would be likely to increase problems of “stepping ahead” of limit orders.
- *“Quote normalization” approach.* This alternative would apply a universal rounding convention to all access fees—fees smaller than a certain amount would be rounded to zero and fees larger than a certain amount would be rounded to one cent. This alternative was dismissed because of likelihood it would impair price transparency and produce inaccurate market information, as orders would be displayed at prices that were slightly higher or lower than the actual price.
- *Outright ban on access fees.* Absent added access fees, quoting conventions would be more comparable across market centers. However, the Proposing Release notes that the business plans of many ECNs rely on access fees and eliminating access fees might serve to decrease competition among market centers.
- *De minimis fee standard.* Ultimately, the SEC decided to propose a *de minimis* access fee standard. Under proposed Rule 610 of NMS, all quoting market centers, quoting market participants and broker-dealers that display attributable quotes through SROs would be permitted to impose fees for the execution of orders. An individual market participant would be limited to access fees of no more than \$0.001

per share. The accumulation of access fees charged by broker-dealers and the order interaction facility of the SRO could not exceed \$0.002 per share in any transaction. According to the Proposing Release, “limiting access fees to a *de minimis* amount – would promote intermarket access, the standardization of quotations, and the Commission’s goals for the NMS.”

The SEC is requesting comment on, among other things: (1) whether the proposed rules are the appropriate response to the concerns raised by access fees; (2) whether private agreements between members and nonmembers is enough to ensure adequate intermarket access; (3) whether the SEC should mandate automatic execution as a part of its access standards; (4) whether the proposed *de minimis* standard unnecessarily interferes with the business model of ECNs, exchanges and association; and (5) whether the rules adequately address the problem of locked markets.

Regulation NMS Hearing Comments

The first of the two panels discussing the Market Access Proposal consisted of representatives from Nasdaq, the Security Traders Association, and market-making firms. The panel was generally in favor of the Market Access Proposal and believed that linkage to market venues through members of an SRO and through the customers of ECNs or market makers on a non-discriminatory basis will be sufficient to assure fair and efficient access to displayed quotes. It was widely recognized that open and efficient access to quotes from market centers is essential to the adoption of the Trade-Through Proposal. Certain panelists were of the view that the adoption of Regulation NMS would likely result in fewer instances of locked and crossed markets as “slow markets” such as some of the traditional auction markets become more efficient.

The second panel’s discussion focused on the issue of access fees charged by quoting market participants. There was a divergence of opinion on the panel, ranging from a view expressed by a representative of a broker-dealer that access fees are unnecessary and should be

¹⁵ Sub-penny pricing and Regulation NMS’s Sub-Penny Pricing Proposal are discussed in greater detail below.

banned outright, to the view expressed by a representative of an ECN that access fees are necessary and are sufficiently controlled by competition among quoting market participants. Panelists expressed concern about connectivity with quoting market centers and quoting market participants. The panelists generally supported a requirement that any quoting market participant controlling 5% or more of the trading volume in a single stock be required to publish its quotations through an SRO facility until its share of trading reached a point where the costs of direct connections with multiple market participants would not be out of proportion to the entity's level of trading. Some panelists believed that direct regulation of smaller quoting market participants by requiring them to clear trades through SROs that impose maximum access fee requirements would be more effective than having SEC-mandated across the board fee requirements. One panelist expressed concern that SEC-mandated fees would result in further consolidation of quoting market participants and increase barriers of entry to new participants. Panelists were also generally of the view that locked and crossed markets resulted from inefficiencies in the market and the practice of payment for order flow. Certain panelists were of the view that the most effective way to address issues causing locked and crossed markets was through direct regulation, including enforcement of rules prohibiting such practices.

SEC Request for Additional Public Comments

During the hearing, panelists expressed concern about the potential costs of connectivity with smaller quoting market centers and quoting market participants. The SEC is requesting comment on whether market participants currently have effective and efficient access to quoting market centers and quoting market participants and whether additional requirements are necessary for such access. With respect to access fees, the SEC is soliciting comments on whether a single accumulated fee limitation should be adopted which applies to all market centers and what the appropriate fee level should be. In regard to locked and crossed markets, the SEC is requesting public comments as to whether market participants submitting quotations that are

automatically executable should be allowed to lock or cross quotations not identified as automatically executable (i.e., manual quotes). Finally, the SEC renewed its request for comment on whether or not access fee limitations should be adopted or whether alternative measures could be taken such as charging different fees to different types of quotations.

Sub-Penny Pricing Proposal

As part of the conversion to decimal pricing in April 2001, each major market established, and the SEC approved, a minimum quoting convention of \$0.01. However, with increasing frequency, ECNs have begun to display quotations on their proprietary systems in sub-penny increments. The problem arises because these quotes are rounded to the nearest penny by markets and securities information processors and are not included in the quotation data disseminated to the public. Broker-dealers, though, can access these sub-penny quotes and obtain better prices than on Nasdaq or the exchanges. The Proposing Release characterizes this absence of sub-penny pricing from published quotes as "creating 'hidden markets' where securities trade in prices not transparent to the general public."

In 2003, the Nasdaq filed a proposal with the SEC that would permit securities traded through its systems to quote in increments of \$0.001. At the same time, the Nasdaq also filed a proposal requesting that the SEC adopt a rule requiring market participants to trade and quote Nasdaq securities in a "consistent monetary increment."¹⁶ In the Proposing Release, the SEC expresses concern that the benefits of sub-penny pricing (i.e., marginally better prices) are not sufficient to justify the costs, which the SEC believes to be a decrease in market depth and an increase in market participants "stepping ahead" of limit orders for economically insignificant amounts.

¹⁶ See Letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, SEC File No. S7-11-03 (Aug. 4, 2003).

The Sub-Penny Pricing Proposal would prohibit every national securities exchange, national securities association, ATS (including ECNs), vendor, broker or dealer from ranking, displaying or accepting from any person a bid or offer, an order or an indication of interest in any NMS stock in an increment less than \$0.01.¹⁷

According to the Proposing Release, the Sub-Penny Pricing Proposal is intended to “ensure that a market participant can only receive execution priority over standing limit orders by improving the best displayed price by more than a nominal amount (*i.e.*, by at least a penny per share).” The Sub-Penny Pricing Proposal does not prohibit an exchange or association from reporting or “printing” a trade in a sub-penny increment. Thus, it would be consistent with the Sub-Penny Pricing Proposal for a broker-dealer to provide price improvement to a customer order in an amount that resulted in an execution in an increment below a penny, so long as the broker-dealer did not accept orders that already were priced in increments below a penny. The Sub-Penny Pricing Proposal does not contemplate a prohibition on sub-penny trading, only sub-penny quoting.

The SEC is seeking comment on a number of questions including, among others: (1) the costs and benefits of the sub-penny quoting prohibition; (2) the advantages and disadvantages of the SEC’s proposal versus Nasdaq’s request for action; (3) whether the Sub-Penny Pricing Proposal addresses the concerns raised by sub-penny pricing; (4) whether the Sub-Penny Pricing Proposal should be expanded to prohibit sub-penny trading; (5) whether there are any types of securities that should be excluded from the Sub-Penny Pricing Proposal; and (6) whether the Sub-Penny Pricing Proposal would further the goals of the NMS.

Regulation NMS Hearing Comments

The panel was generally supportive of the Sub-Penny Pricing Proposal and believed a requirement of imposing a minimum quote increment of \$0.01 would level the

market place between institutional investors, who traditionally have access to sub-penny quotes, and retail investors, who do not. Certain panelists noted, however, that the prohibition on sub-penny quoting may lead to increased costs to institutional investors.

Market Data Proposal

Pursuant to joint industry plans and current SEC rules, quotes and trades from various market centers are collected, consolidated and disseminated to the public. After Congress enacted Section 11A of the Exchange Act, the SEC adopted rules regulating arrangements for disseminating market data to the public — Rules 11Aa3-1, 11Ac1-1, and 11Ac1-2 under the Exchange Act. In order to comply with these rules, SRO members participate in one of three joint industry plans. Each of these plans has its own network that disseminates market data to the public: (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 (the “Networks”). The Networks determine fees for disseminating market data, which must be approved by the SEC.

In 2000, the SEC established an Advisory Committee on Market Information, whose purpose was to discuss and explore, among other things, models for collecting and disseminating market data. The Advisory Committee made a number of recommendations, including: (1) retaining price transparency and consolidated market information as core elements of the U.S. securities markets; (2) permitting market centers to distribute additional information, such as depth of limit order book, free from mandatory consolidation requirements; (3) adopting a “competing consolidators” model of data dissemination; (4) broadening governance of the joint industry plans through non-voting committees; and (5) rejecting a cost-based approach for reviewing fees.¹⁸ The proposed market data rule amendments found in

¹⁷ The Sub-Penny Pricing Proposal would not apply to options, although the SEC is seeking comment on whether options should be included within the prohibition on sub-penny pricing.

¹⁸ See *Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change* (Sep. 14, 2001), available at www.sec.gov/divisions/marketreg/marketinfo/finalreport.htm.

proposed Regulation NMS would implement most of these recommendations.

The current market data model includes the consolidated display requirement, the joint industry plans and the Networks. In addition to the current model, the SEC considered three alternative models. While ultimately deciding not to propose an alternative model, the Proposing Release discusses the SEC's analysis of the models and seeks public comment on their utility. The alternatives include:

- *Deconsolidation model.* This model would eliminate the requirement that broker-dealers and vendors provide customers with consolidated market data, which would eliminate the need for the joint industry plans and the Networks. While such a model would allow competitive forces to determine data products, fees and SRO revenues, the SEC believes this model has an increased risk of confusion and harm to retail investors. Retail investors would have to monitor and evaluate the quality of best quotes from a variety of sources for a single security. The Proposing Release states, "Retail investors should not be required to become experts on market structure to participate directly in the equity markets with confidence that they will receive a fair deal" and that a benefit of the current model of data dissemination is "assuring retail investors ready access to consolidated prices." An additional problem is that a dominant securities market's trade and quote information may be so necessary that that market can charge monopoly-like fees for its information.
- *Competing consolidators model.* Under this model, consolidation would still be required, but each SRO would independently establish its own fees as long as they were not unreasonably discriminatory and enter into its own market data contracts. This model would also eliminate the need for the joint industry plans and the Networks. While the Advisory Committee found a number of benefits to this option — for example, greater ability for market participants

to innovate, elimination of potential antitrust exposure due to the participation in joint industry plans, and elimination of artificial cooperation imposed by the joint industry plans — the SEC felt these benefits did not outweigh the drawbacks, which include a loss of uniformity in publicly disseminated data due to the use of multiple consolidators and a failure to introduce additional competing forces in the determination of data fees and receipt of revenue by the SROs. The Commission felt that while the SROs would be the recipients of the most significant benefits under this alternative, investors and data users would bear the significant potential risk of higher fees for lower quality information.

- *Hybrid model.* This model would retain key elements of the current model for quotes representing the NBBO but deconsolidate all trade reporting and all quotes other than the NBBO. Each SRO would distribute its non-NBBO data separately. This model would preserve a minimum level of the consolidated data most needed by retail investors, while allowing market forces to determine fees for trades and non-NBBO quotes. According to the Proposing Release, "In the absence of a consolidated display requirement, investors and data users would be free to not purchase an SRO's data if they believed its value did not justify the fee." However, this model also suffers from concerns about the quality of deconsolidated data and whether market forces would be sufficient to preserve wide availability of market data. As with the competing consolidators model, a market with significant share of trading in NMS stocks could exercise considerable market power in setting fees.

SEC is seeking comment on the relative strengths and weaknesses of not only the current model, but also each of these alternatives. Of particular concern is whether investors would fare better under one of the alternative models or some other alternative not considered by the SEC.

Allocation of Network Net Income

The SEC is proposing changes to the current formulas by which the joint industry plans allocate net market data income to their SRO participants (“Formula Amendments”). The current formulas are based on an SRO’s number of reported trades or share volume of reported trades in Network securities.¹⁹ The SEC believes that this focus on the number of trades and share volume of trading have “caused a variety of economic and regulatory distortions.” For example, the current formulas do not reward market centers that generate quotes that have the largest sizes and the best prices (*i.e.*, the highest quality quotes). The Proposing Release also suggests the current formulas incentivize distortive practices, such as reporting a large number of very small trades or engaging in wash trades to generate market data revenue.

The proposed Formula Amendments seek to “incorporate a more broad based measure of contribution of an SRO’s quotes and trades to the consolidated data stream” using a two-step process. First, a Network’s distributable net income would be allocated among the many individual securities included in that Network’s data stream. Then, the net income that is allocated to an individual security would be allocated among the SROs based on measures of utility of their trades and quotes in the security. Under the Formula Amendments, the SRO participants are entitled to receive an annual payment for each calendar year equal to the sum of the SRO’s Trading Shares, Quoting Shares, and NBBO Improvement Shares in each Network security.²⁰ The Trading Share represents the SRO’s proportion of trading in each Network security. The Quoting Share is the SRO’s proportion of quotes that equal the NBBO in each Network security. Finally, the NBBO Improvement Share is the SRO’s proportion of quotes that improve the price of the NBBO in each Network security.

¹⁹ Networks A and B allocate net income based solely on the number of trades reported by an SRO. Network C allocates net income based on the average of a participant’s number of trades and its share volume.

²⁰ The text of the Formula Amendment can be found in section IX of the Proposing Release, *supra* n. 1.

The SEC is seeking comment on the Formula Amendments generally, as well as each element of the formula. Additionally, the SEC is requesting comment on whether shifts in allocation of Network net income will promote or detract from self-regulation of the markets. Finally, the SEC is seeking comment on whether the formula should be modified if market centers continue to charge fees to access their quotes.

Plan Governance Changes

The SEC is also proposing an amendment to the Plans that would broaden participation in Plan governance (the “Governance Amendment”). Under the current regime, each Plan is governed by operating committees that are composed of one representative from each participating SRO. The Governance Amendment would require the Plans to create non-voting advisory committees. The operating committee would select, by majority vote, members to serve for two-year terms and representing one of a number of categories.²¹ Additionally, each SRO would be allowed to select one committee member that is not employed by or affiliated with any participant. The Governance Amendment also sets forth the functions of the committee: “to assure that its members have an opportunity to submit their views to the operating committees on Plan matters, prior to any decision by the operating committee.” To perform this function, advisory committee members would have the right to attend regular meetings of the operating committee; however, the operating committee would be able to determine, by majority vote, that a business item required confidential treatment.

The SEC is seeking comment on whether this amendment achieves the goal of broadening governance participation and whether other categories of interested parties should be included as members of advisory committees. Also, the SEC is requesting comment on whether it is appropriate for advisory committee members to attend meetings of the operating committee.

²¹ These categories include: (1) a broker-dealer with a substantial retail investor customer base, (2) a broker-dealer with a substantial institutional customer base, (3) an ATS, (4) a data vendor and (5) an investor.

Distribution and Display Changes

Currently, Rule 11Aa3-1(c)(2) and (c)(3) prohibit SROs and their members from disseminating their trade reports independently. Proposed Rule 601 of Regulation NMS would rescind these paragraphs. Under Proposed Rule 601, SRO members would still be required to transmit their trades to the SRO, but members would also be free to independently distribute their own data. Proposed Rule 603 also creates uniform standards for distribution of quotes and trades. First, an exclusive processor would be required to make available any market information they distribute to securities information processors on terms that are fair and reasonable. Second, any SRO, broker or dealer that distributes market information must do so on terms that are not unreasonably discriminatory. This language — “fair and reasonable” and “not unreasonably discriminatory” — is designed to track the language of Section 11A(c) of the Exchange Act.

Currently, all of the SROs participate in Plans that provide for dissemination of consolidated information for NMS stocks. The proposed amendment would require existing (and new SROs) to participate in joint-SRO plans and that consolidated information disseminated under the plans would be required to include an NBBO that is calculated in accordance with the proposed definition in Rule 600 of Regulation NMS.²² Additionally, these plans must provide for the dissemination of all consolidated information for an individual NMS Stock through a single processor.

Under the current regime, vendors must provide a consolidated display that encompasses information from all market centers that trade an NMS Stock, if they provide any display of market information in that stock.

²² Rule 600 defines NBBO as “the best bid and best offer for such security that are calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan; *provided*, that in the event two or more market centers transmit to the plan processor pursuant to such plan identical bids or offers for an NMS security, the best bid or best offer (as the case may be) shall be determined by ranking all such identical bids or offers (as the case may be) first by size (giving the highest ranking to the bid or offer associated with the largest size), and then by time (giving the highest ranking to the bid or offer received first in time).”

While the proposed amendments would retain this requirement, these amendments would reduce the information that must be included in a consolidated display to prices, sizes, market center identifications of the NBBO and most recent last sale information. Additional information could be included if providers desired. The amendments also limit the contexts in which a vendor is required to provide a consolidated display. Consolidated displays would be required only in situations in which a trading or order-routing decision could be implemented, but not when, for example, market data is provided on a purely informational website that does not offer any trading or order-routing capability. Finally, the proposed amendments eliminate the “keystroke retrieval” requirements and simply would require that consolidated data be made available in a manner equivalent to other data.

The SEC is seeking comment on whether these proposed amendments to the distribution and display aspects of the NMS plans achieve the goal of giving investors the information they need to make informed trade decisions and to evaluate whether brokers are providing best execution of orders. The SEC is also requesting comment on whether there should be a “phase-in” period to allow market participants to adapt to these provisions. Finally, the SEC is seeking comment on whether it should adopt alternative models for disseminating market data to the public.

Regulation NMS Hearing Comments

The panel, consisting of representatives of the major stock exchanges and large financial institutions, engaged in a lively discussion regarding the costs of market data and the proposed adoption of the new broad-based formula for measuring the value of a SRO’s quotes and trades to the marketplace. Various panelists expressed concern that the proposal did not directly address the issue of the cost charged by SROs for access to market data, which many considered excessive in relation to the costs of compiling such data. In support of this assertion, Robert Greifeld stated that the Nasdaq typically charges \$20.00 for access to basic market data (a Level I quote) that is compiled for a cost of approximately \$5.00 to \$7.00. Robert Britz, speaking on

behalf of the NYSE, noted, however, that the cost of compiling data varies by SRO, and that the cost structure and profit margins for NYSE and Amex market data may differ from that of Nasdaq. One panelist suggested that public disclosure of SRO market data revenues and profits instead of regulation would lead to increased competition among SROs and decrease costs. Panelists also expressed reservations over the adoption of the Formula Amendments noting the complexity of the formula and its susceptibility to gaming by an SRO seeking to increase revenues.

SEC Request for Additional Public Comments

In light of panelists’ comments regarding the costs of market data, the SEC is requesting public comment regarding the reasonableness of current fee levels. The SEC noted that the panelists did not discuss the costs of producing full quotation data (Level II data). With respect to the revenue allocation formula, the SEC also

noted that the difficulty and cost of implementing the formula may have been over stated at the hearing as all the market data necessary to make the calculations is currently disseminated to data vendors. The SEC is, however, requesting additional comments on potential implementation costs and on possible ways to minimize such costs, such as by utilizing a single data vendor. The SEC is also requesting comment on certain possible changes to the formula relating to the manual quotes, including the elimination of the automatic cutoff for manual quotes designed to minimize the reward for quotes that become stale during the process of being manually updated and excluding manual quotes from the calculation of “quoting shares”. The Commission also is requesting comment on whether, if manual quotes were excluded from the calculation of Quoting Shares, the proposed additional measure of quoting activity – the proposed NBBO Improvement Share – should be eliminated from the formula.



Dechert LLP continues to monitor these and other developments and will issue Financial Services Updates when warranted. If you have questions

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