

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR PARTS 200, 201, 230, 240, 242, 249, and 270

[Release No. 34-50870; File No. S7-10-04]

RIN 3235-AJ18

### Regulation NMS

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rules and amendments to joint industry plans.

**SUMMARY:** The Securities and Exchange Commission (“Commission”) is repropounding rules under Regulation NMS and two amendments to the joint industry plans for disseminating market information. In addition to redesignating the national market system rules previously adopted under Section 11A of the Securities Exchange Act of 1934 (“Exchange Act”), Regulation NMS would include new substantive rules that are designed to modernize and strengthen the regulatory structure of the U.S. equity markets. First, the “Trade-Through Rule” would require trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by other trading centers, subject to an applicable exception. To be protected, a quotation must be immediately and automatically accessible. Second, the “Access Rule” would require fair and non-discriminatory access to quotations, establish a limit on access fees to harmonize the pricing of quotations across different trading centers, and require each national securities exchange and national securities association to adopt and enforce rules that prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross automated quotations. Third, the “Sub-Penny Rule” would prohibit market participants from accepting, ranking, or displaying orders, quotations, or indications of interest in a pricing increment smaller than a penny, except for orders, quotations, or indications of interest that are priced at less than \$1.00 per share. Finally, the Commission is repropounding amendments to the “Market Data Rules” that would update the requirements for consolidating, distributing, and displaying market information, as well as amendments to the joint industry plans for disseminating market information that would modify the formulas for

allocating plan revenues (“Allocation Amendment”) and broaden participation in plan governance (“Governance Amendment”).

**DATES:** Comments must be received on or before January 26, 2005. Given the advanced stage of this rulemaking initiative, the Commission anticipates taking further action as expeditiously as possible after the end of the comment period. It therefore strongly encourages the public to submit their comments within the prescribed comment period. Comments received after that point cannot be assured of full consideration by the Commission.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-10-04 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609.

All submissions should refer to File Number S7-10-04. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments also are available for public inspection and copying in the Commission’s Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

#### FOR FURTHER INFORMATION CONTACT:

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#### SUPPLEMENTARY INFORMATION:

##### Table of Contents

- I. Introduction
  - A. Need for Modernization of the NMS
  - B. Objectives for Future NMS
  - C. Overview of Reproposed Rules
    1. Trade-Through Rule
    2. Access Rule
    3. Sub-Penny Rule
    4. Market Data Rules and Plans
- II. Trade-Through Rule
  - A. Response to Comments and Basis for Reproposed Rule
    1. Need for Intermarket Trade-Through Rule
    2. Limiting Protection to Automated and Accessible Quotations
    3. Workable Implementation of Intermarket Trade-Through Protection
    4. Elimination of Proposed Opt-Out Exception
    5. Scope of Protected Quotations—Market BBO Alternative and Voluntary Depth Alternative
    6. Benefits and Implementation Costs of Trade-Through Rule
  - B. Description of Reproposed Rule
    1. Scope of Rule
    2. Requirement of Reasonable Policies and Procedures
    3. Exceptions
    4. Duty of Best Execution
- III. Access Rule
  - A. Response to Comments and Basis for Reproposed Rule
    1. Access to Quotations
    2. Limitation on Access Fees
    3. Locking or Crossing Quotations
  - B. Description of Reproposed Rule
    1. Access to Quotations
    2. Limitation on Access Fees
    3. Locking or Crossing Quotations
    4. Regulation ATS Fair Access
- IV. Sub-Penny Rule
  - A. Background
  - B. Commission Proposal on Sub-Penny Quoting
  - C. Comments Received
    1. Comments Addressing Overall Proposal
    2. Response to Other Comments
  - D. Exemptive Authority
- V. Market Data Rules and Plan Amendments
  - A. Response to Comments and Basis for Reproposed Rules
    1. Alternative Data Dissemination Models
    2. Level of Fees and Plan Governance
    3. Revenue Allocation Formula
    4. Distribution and Display of Data
  - B. Description of Reproposed Rules and Amendments
    1. Allocation Amendment

- 2. Governance Amendment
- 3. Consolidation, Distribution, and Display of Data
- VI. Regulation NMS
- VII. General Request for Comment
- VIII. Paperwork Reduction Act
- IX. Consideration of Costs and Benefits
- X. Consideration of Burden on Competition, and Promotion of Efficiency, Competition and Capital Formation
- XI. Consideration of Impact on the Economy
- XII. Regulatory Flexibility Act
- XIII. Statutory Authority
- XIV. Text of Reproposed Amendments to the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan
- XV. Text of Reproposed Rules

## I. Introduction

The Commission is reproposing Regulation NMS, a series of initiatives designed to modernize and strengthen the national market system (“NMS”) for equity securities.<sup>1</sup> These initiatives include:

(1) A new Trade-Through Rule, which would establish for all NMS stocks the fundamental principle of price priority for automated quotations that are immediately accessible;

(2) A new Access Rule, which would promote fair and non-discriminatory access to quotations displayed by NMS trading centers through a private linkage approach;

(3) A new Sub-Penny Rule, which would establish a uniform quoting increment of no less than one penny for quotations in NMS stocks equal to or greater than \$1.00 per share to promote greater price transparency and consistency;

(4) Amendments to the Market Data Rules and joint industry plans that would allocate plan revenues to self-regulatory organizations (“SROs”) for their contributions to public price discovery and promote wider and more efficient distribution of market data; and

(5) A reorganization of existing Exchange Act rules governing the NMS to promote greater clarity and understanding of the rules.

The NMS encompasses the stocks of more than 5000 listed companies, which collectively represent more than \$14 trillion in U.S. market capitalization. NMS stocks are traded simultaneously at a variety of different venues, including national securities exchanges, alternative trading systems (“ATSs”), and market-making securities dealers. Fair and efficient trading of NMS stocks

is essential if the equity markets are to meet the long-term investment needs of the public and to reduce the cost of capital for listed companies. Section 11A of the Exchange Act charges the Commission with facilitating the establishment of an NMS that links multiple trading centers into a unified system that promotes the fairest and most efficient equity markets possible. The reproposed rules are intended to assure that the NMS remains up to date and continues to serve the interests of investors, listed companies, and the public.

### A. Need for Modernization of the NMS

The reproposed rules would implement a major overhaul of the existing structure of the NMS, much of which was originally designed in the 1970s and 1980s. This overhaul is necessary to respond to sweeping changes that have reshaped the equity markets in recent years. First, communications and trading technologies have greatly expanded the available options for routing and executing orders in NMS stocks. Establishing connectivity among all types of securities industry participants has become both less costly and more flexible. Order-routing systems can be programmed to monitor prices at multiple trading centers, assess the most effective trading strategy to meet the needs of a particular customer, and instantaneously route orders to one or more trading centers to implement that strategy. Trading centers, in turn, are able to offer a near instantaneous response to incoming orders seeking to access automated quotations.

Another significant change has been the intensified competition among different types of markets that simultaneously trade many of the same NMS stocks, regardless of the particular market where the stocks are listed. These include (1) Traditional exchanges with active trading floors, which even now are evolving to expand the range of choices that they offer investors for both automated and manual trading; (2) purely electronic markets, which offer both standard limit orders and conditional orders that are designed to facilitate complex trading strategies; (3) market-making securities dealers, which offer both automated execution of smaller orders and the commitment of capital to facilitate the execution of larger, institutional orders; (4) regional exchanges, many of which have adopted automated systems for executing smaller orders; and (5) automated matching systems that permit investors, particularly large institutions, to seek

counter-parties to their trades with minimal publicity and price impact.

Finally, the initiation of trading in penny increments in 2001 transformed the equity markets. The number of quotation updates increased, and the quoted size at any particular price level dropped. The change clearly has benefited many investors, particularly retail investors that typically use smaller orders. Reducing the standard trading increment from  $\frac{1}{16}$ ths to pennies allowed effective spreads to narrow for small orders.<sup>2</sup> As a result, the trading costs of small orders have dropped dramatically.<sup>3</sup>

For institutional investors that generally need to trade in large sizes, however, the results of decimal trading have been less clear cut. The primary component of trading costs for large orders is price impact—the change in stock price caused by the difficulty of executing large orders to buy (with rising prices) or to sell (with declining prices).<sup>4</sup> The price impact for large orders, which generally will be many times the effective spread for small orders in the same stock, is largely determined by market depth and liquidity. The greater the depth and liquidity, the less the price impact of large orders. Given that millions of individuals invest in NMS stocks indirectly through these institutions, it is vitally important for the NMS to promote depth and liquidity for the trading of large orders.

To respond to all of these changes, the Commission has undertaken a deliberate and systematic review of market structure. We actively have sought out the views of the public and securities industry participants. Even prior to formulating proposals, our review included multiple public hearings and roundtables, an advisory committee, three concept releases, the issuance of temporary exemptions intended in part to generate useful data on policy alternatives, and a constant dialogue with industry participants and investors. This process continued after

<sup>2</sup> For small orders, the effective spread between bid and offer prices represents the most significant implicit trading cost. In addition to the implicit trading costs associated with the prices at which their orders are executed, investors must pay explicit costs of trading, such as broker commissions.

<sup>3</sup> Effective spreads declined substantially almost immediately after decimalization, and had declined an additional 40% by November 2003. Proposing Release, 69 FR at 11128, 11165.

<sup>4</sup> See Securities and Exchange Commission, Release Nos. 33–8349 (Dec. 18, 2003), 68 FR 74820, 74822 (Dec. 24, 2003) (concept release on measures to improve disclosure of mutual fund transaction costs; notes that estimates of price impact costs range from 0.18% to 1.0% of the principal amount of transactions).

<sup>1</sup> The Commission originally proposed Regulation NMS in February 2004. Securities Exchange Act Release No. 49325 (Feb. 26, 2004), 69 FR 11126 (Mar. 9, 2004) (“Proposing Release”). It issued a supplemental request for comment in May 2004. Securities Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 (May 26, 2004) (“Supplemental Release”).

the proposals were published for public comment.<sup>5</sup> We held a public hearing on the proposals in April 2004 (“NMS Hearing”).<sup>6</sup> To give the public an opportunity to respond to important developments at the hearing, we published a supplemental request for comment and extended the comment period on the proposals.<sup>7</sup> The public submitted more than 700 comment letters that encompassed a wide range of views. On one point, however, commenters agreed—the time has come to modernize the NMS.

The Commission believes that the insights of the commenters, as well as those of the NMS Hearing panelists, have contributed to significant improvements in the original proposals. Responding appropriately to these comments has caused the repropoed rules to differ in some respects from the rule text as originally proposed. As discussed extensively below, all of the changes address issues that were raised in the Proposing Release and Supplemental Release and that prompted substantial public comment. Rather than adopt rules at this point, however, the Commission is implementing a reproposal process to afford the public an additional opportunity to review and comment on the details of the rules. Given the advanced stage of rulemaking, it anticipates taking further action as expeditiously as possible after the end of the comment period. The Commission therefore strongly encourages the public to submit their comments within the comment period. Comments received after that point cannot be assured of full consideration by the Commission. In its evaluation of further rulemaking action, the Commission will consider, in addition to the comments received in response to this release, all comments received on the Proposing Release and Supplemental Release.

### B. Objectives for Future NMS

The repropoed rules are designed to strengthen the NMS in three primary ways. First, they would update antiquated rules that no longer adequately serve the purposes for which they were adopted. Second, they would help level the competitive playing field by promoting equal regulation of different types of stocks and markets. Third, they would promote greater order interaction and displayed depth, of

particular value for the large orders of institutional investors.

Taken together, the Commission believes the repropoed rules would significantly improve the fairness and efficiency of the NMS in the future. The NMS is premised on promoting fair competition among markets, while at the same time assuring that all of these markets are linked together, through facilities and rules, in a unified system that promotes interaction among the orders of buyers and sellers in a particular NMS stock. The NMS thereby incorporates two distinct types of competition—competition among individual markets and competition among individual orders—that together contribute to efficient markets. Vigorous competition among markets promotes more efficient and innovative trading services, while integrated competition among orders promotes more efficient pricing of individual stocks. Together, they produce markets that offer signal benefits for investors and listed companies.

The Commission has sought to avoid the extremes of (1) isolated markets that trade an NMS stock without regard to trading in other markets and thereby fragment the competition among buyers and sellers in that stock, and (2) a totally centralized system that loses the benefits of vigorous competition and innovation among individual markets. To achieve the appropriate degree of integration, the Commission primarily has relied on two tools. First, consolidated display of market data promotes transparency of the best prices for an NMS stock. Second, intermarket “rules of the road” establish a framework within which competition among individual markets can flourish on terms that ultimately benefit investors. The repropoed rules would continue this strategy. They are designed to strengthen and enhance the efficiency of linkages among the various competing markets, but without mandating any particular type of trading model. Investor choice and competition will determine the relative success or failure of the various competing markets.

Some have suggested that the Commission should move away from the fundamental NMS concept of promoting both competition among markets and competition among the buyers and sellers in a stock. They believe that, instead, markets should be allowed to trade in isolation from one another. This approach, of course, was in effect until 1975 when Congress directed the Commission to facilitate the establishment of an NMS. After fully considering the matter, Congress

specifically found that linking the individual markets would “foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors’ orders, and contribute to the best execution of such orders.”<sup>8</sup> The wisdom of this congressional finding has been proven by thirty years of practical experience. The NMS needs to be enhanced and modernized, not because it has failed investors, but because it has been so successful in promoting growth, efficiency, innovation, and competition that many of its old rules now are outdated. Since the NMS was created nearly thirty years ago, trading volume has exploded, competition among market centers has intensified, and investor trading costs have shrunk dramatically. The Commission preliminarily believes that the repropoed rules would contribute to further growth and efficiency in the NMS and thereby serve the interests of investors, listed companies, and the public in the future.

### C. Overview of Repropoed Rules

#### 1. Trade-Through Rule

The Trade-Through Rule (repropoed Rule 611 under Regulation NMS)<sup>9</sup> would establish intermarket protection against trade-throughs for all NMS stocks. A trade-through occurs when one trading center executes an order at a price that is inferior to the price of a protected quotation, often representing an investor limit order, displayed by another trading center.<sup>10</sup> Many commenters on the proposals, particularly large institutional investors, strongly supported the need for enhanced protection of limit orders against trade-throughs.<sup>11</sup> They

<sup>8</sup> Section 11A(a)(1)(D) of the Exchange Act.

<sup>9</sup> Although this release refers to repropoed Rule 611 as the “Trade-Through Rule,” the text of the Rule would be named “Order Protection Rule” if adopted. The term “Trade-Through Rule” is used in this release to avoid confusion, given that the term has been widely used in public debate. The term “Order Protection Rule,” however, better captures the Commission’s purpose for the Rule. Specifically, it is designed to protect both (1) limit orders represented by displayed and automated quotations, by prohibiting trading centers from executing trades at inferior prices; and (2) market orders and marketable limit orders (which have limit prices that render them subject to immediate execution at market prices without display), by requiring trading centers either to execute the orders at the best, immediately accessible prices or to route the orders to trading centers displaying such prices.

<sup>10</sup> The nature and scope of quotations that would be protected under the Trade-Through Rule are discussed in detail in sections II.A.2 and II.B.1 below.

<sup>11</sup> See *infra*, note 38 (overview of commenters supporting trade-through proposal).

<sup>5</sup> Proposing Release, 69 FR at 11126.

<sup>6</sup> A full transcript of the NMS Hearing (“Hearing Tr.”), as well as an archived video and audio webcast, is available on the Commission’s Internet Web site (<http://www.sec.gov>).

<sup>7</sup> Supplemental Release, 69 FR at 30142.

emphasized that limit orders are the building blocks of public price discovery and efficient markets. They stated that a uniform rule for all NMS stocks, by enhancing protection of displayed prices, would encourage greater use of limit orders and contribute to increased market liquidity and depth. The Commission preliminarily agrees that strengthened protection of displayed limit orders would help reward market participants for displaying their trading interest and thereby promote fairer and more vigorous competition among orders seeking to supply liquidity. It therefore has decided to repropose Rule 611 to strengthen the protection of displayed and automatically accessible quotations in NMS stocks. As discussed below, today we are proposing two alternatives that would each further this goal, and we are seeking public comment on which alternative is likely best to advance the principle of limit order protection while preserving intermarket competition and avoiding practical implementation problems.

As with the original proposal, the repropose Trade-Through Rule would take a substantially different approach than the trade-through provisions currently set forth in the Intermarket Trading System ("ITS") Plan,<sup>12</sup> which apply only to exchange-listed stocks. The ITS provisions are not promulgated by the Commission, but rather are rules of the markets participating in the ITS Plan. These rules were drafted decades ago and do not distinguish between manual and automated quotations. Moreover, they state that markets "should avoid" trade-throughs and require an after-the-fact complaint procedure pursuant to which, if a trade-through occurs, the aggrieved market may seek satisfaction from the market that traded through. Finally, the ITS provisions have significant gaps in their coverage, particularly for large, block transactions (10,000 shares or greater), that have seriously weakened their protection of limit orders.

<sup>12</sup> The full title of the ITS Plan is "Plan for the Purpose of Creating and Operating an Intermarket Communications Linkage Pursuant to Section 11A(c)(3)(B) of the Securities Exchange Act of 1934." The ITS Plan was initially approved by the Commission in 1978. Securities Exchange Act Release No. 14661 (Apr. 14, 1978), 43 FR 17419 (Apr. 24, 1978). All national securities exchanges that trade exchange-listed stocks and the NASD are participants in the ITS Plan. It requires each participant to provide electronic access to its displayed best bid or offer to other participants and provides an automated mechanism for routing orders, called commitments to trade, to access those displayed prices. The participants also agreed to avoid trade-throughs and locked markets and to adopt rules addressing such practices.

In contrast, the repropose Trade-Through Rule would only protect quotations that are immediately accessible through automatic execution. It thereby would address a serious weakness in the ITS provisions, which were drafted for a world of floor-based markets and fail to reflect the disparate speed of response between manual and automated quotations. By requiring order routers to wait for a response from a manual market, the ITS trade-through provisions can cause an order to miss both the best price of a manual quotation and slightly inferior prices at automated markets that would have been immediately accessible. The Trade-Through Rule would eliminate this potential inefficiency by protecting only automated quotations. It also would promote equal regulation and fair competition among markets by eliminating any potential advantage that the ITS trade-through provisions may have given manual markets over automated markets.

In addition, the repropose Trade-Through Rule incorporates an approach to trade-throughs that is stricter and more comprehensive than the ITS provisions. First, it would require trading centers to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs, or, if relying on one of the rule's exceptions, that are reasonably designed to assure compliance with the exception. To assure effective compliance, such policies and procedures would need to incorporate objective standards that were coded into a trading center's automated systems. Moreover, a trading center would be required to regularly surveil to ascertain the effectiveness of its policies and procedures and to take prompt action to remedy deficiencies. Second, the Trade-Through Rule would eliminate very significant gaps in the coverage of the ITS provisions that have undermined the extent to which they protect limit orders and promote fair and orderly trading. In particular, the ITS provisions do not cover the large transactions of broker-dealers acting as block positioners in exchange-listed stocks. They also exclude trade-throughs of 100-share quotations, thereby allowing the limit orders of small investors to be bypassed. The Trade-Through Rule would close both of these gaps in coverage.

With respect to the scope of quotations to be protected, the Commission is proposing two alternatives, one of which would represent a more fundamental departure from the existing ITS provisions by potentially extending limit-order

protection beyond the best limit orders on a market's book. The definition of "protected bid" or "protected offer" in paragraph (b)(57) of repropose Rule 600 controls the scope of quotations that would be protected by the Trade-Through Rule. The first alternative ("Market BBO Alternative") would protect only the best bids and offers ("BBOs") of the nine self-regulatory organizations ("SROs") and The Nasdaq Stock Market, Inc. ("Nasdaq") whose members currently trade NMS stocks. The scope of quotations covered by this alternative is comparable to the ITS provisions. The second alternative ("Voluntary Depth Alternative") also would protect the BBOs of the various SROs and Nasdaq, but would establish a mechanism for a market *voluntarily* to secure protection for its depth-of-book quotations at prices below its best bid or above its best offer. These alternatives are discussed in more detail in section II.A.5 below.

The rule text of the original proposal included a general "opt-out" exception that would have allowed market participants to disregard displayed quotations. Such an exception would have left a significant gap in protection of the best displayed prices and thereby severely reduced the proposal's potential benefits. The elimination of any protection for manual quotations is the principal reason that this broad exception is no longer necessary in the Trade-Through Rule as repropose. In addition, the Rule adds a number of tailored exceptions that carve out those situations in which many investors may otherwise have felt they legitimately needed to opt-out of a displayed quotation. These exceptions are more consistent with the principle of protecting the best price than a general opt-out exception. The additional exceptions also would help assure that the Trade-Through Rule is workable for high-volume stocks. Examples of these exceptions include intermarket sweep orders, quotations displayed by markets that fail to meet the response requirements for automated quotations, and flickering quotations with multiple prices displayed in a single second.<sup>13</sup>

Some commenters questioned the need to extend a trade-through rule to Nasdaq stocks.<sup>14</sup> These commenters generally emphasized the much improved efficiency of trading in Nasdaq stocks in recent years. They particularly were concerned that extension of intermarket price protection to Nasdaq stocks, at least in

<sup>13</sup> Flickering quotations are discussed further in section II.A.3 below.

<sup>14</sup> See *infra*, notes 40–42 and accompanying text.

the absence of a general opt-out exception, would interfere with current trading methods.

The Commission preliminarily believes, however, that intermarket price protection would benefit investors and strengthen the NMS in all NMS stocks. It would contribute to the maintenance of fair and orderly markets and, thereby, promote investor confidence in the markets. As discussed below,<sup>15</sup> trade-through rates currently are significant in both Nasdaq and exchange-listed stocks. For example, approximately 1 of every 40 trades in both Nasdaq and NYSE stocks represents a significant trade-through of a displayed quotation. For hundreds of active Nasdaq stocks, approximately 1 of every 11 shares traded is a significant trade-through. The routine execution of trades at prices inferior to those offered by displayed and accessible limit orders is inconsistent with basic notions of fairness and orderliness, particularly for investors, both large and small, who post limit orders and see those orders routinely traded through. These trade-throughs can undermine incentives to display limit orders. Moreover, many of the investors whose market orders are executed at inferior prices may not, in fact, be aware they received an inferior price from their broker and executing market. In sum, the Commission preliminarily believes that a uniform rule establishing price protection on an order-by-order basis is needed to protect the interests of investors, promote the display of limit orders, and thereby improve the efficiency of the NMS as a whole.

## 2. Access Rule

The Access Rule (reproposed Rule 610 under Regulation NMS) would set forth new standards governing access to quotations in NMS stocks. As emphasized by many commenters on the proposals,<sup>16</sup> protecting the best displayed prices against trade-throughs would be futile if broker-dealers and trading centers were unable to access those prices fairly and efficiently. Accordingly, Rule 610 is designed to promote access to quotations in three ways. First, it would enable the use of private linkages offered by a variety of connectivity providers,<sup>17</sup> rather than mandating a collective linkage facility such as ITS, to facilitate the necessary access to quotations. The lower cost and increased flexibility of connectivity in recent years has made private linkages

a feasible alternative to hard linkages, absent barriers to access. Using private linkages, market participants may obtain indirect access to quotations displayed by a particular trading center through the members, subscribers, or customers of that trading center. To promote this type of indirect access, Rule 610 would prohibit a trading center from imposing unfairly discriminatory terms that would prevent or inhibit the access of any person through members, subscribers, or customers of such trading center.

Second, reproposed Rule 610 would limit the fees that any trading center can charge (or allow to be charged) for accessing its protected quotations to no more than \$0.003 per share. The purpose of the fee limitation is to ensure the fairness and accuracy of displayed quotations by establishing an outer limit on the cost of accessing such quotations. For example, if the price of a protected offer to sell an NMS stock is displayed at \$10.00, the total cost to access the offer and buy the stock will be \$10.00, plus a fee of no more than \$0.003. The reproposed rule thereby would assure order routers that displayed prices are, within a limited range, true prices.

The reproposed fee limitation substantially simplifies the proposed limitation on fees, which, in general, would have limited the fees of individual market participants to \$0.001 per share, with an accumulated cap of \$0.002 per share. Perhaps more than any other single issue, the proposed limitation on access fees splintered the commenters.<sup>18</sup> Some supported the proposal as a worthwhile compromise on an extremely difficult issue. They believed that it would level the playing field in terms of who could charge fees, as well as give greater certainty to market participants that quoted prices will, essentially, be true prices. Others were strongly opposed to any limitation on fees, believing that competition alone would be sufficient to address high fees that distort quoted prices. Still others were equally adamant that all access fees of electronic communications networks ("ECNs") charged to non-subscribers should be prohibited entirely, although they did not see a problem with fees charged to a market's members or subscribers. Although consensus could not be achieved on any particular approach, commenters expressed a strong desire for resolution of a difficult issue that has caused discord within the securities industry for many years.

The Commission preliminarily believes that a single, uniform fee limitation of \$0.003 per share would be the fairest and most appropriate resolution of the access fee issue. First, it would not seriously interfere with current business practices, as trading centers have very few fees on their books of more than \$0.003 per share or earn substantial revenues from such fees.<sup>19</sup> Second, the uniform fee limitation would promote equal regulation of different types of trading centers, where previously some had been permitted to charge fees and some had not. Finally and most importantly, the fee limitation of Rule 610 would be necessary to support the integrity of the price protection requirement established by the reproposed Trade-Through Rule. In the absence of a fee limitation, some "outlier" trading centers might take advantage of the requirement to protect displayed quotations by charging exorbitant fees to those required to access the outlier's quotations. Rule 610's fee limitation would preclude the initiation of this business practice, which would compromise the fairness and efficiency of the NMS.

Finally, reproposed Rule 610 would require SROs to establish and enforce rules that, among other things, prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross the automated quotations of other trading centers. Trading centers would be allowed, however, to display automated quotations that lock or cross the *manual* quotations of other trading centers. The reproposed rule thereby would reflect the disparity in speed of response between automated and manual quotations, while also promoting fair and orderly markets by establishing that the first automated quotation at a price, whether it be a bid or an offer, is entitled to an execution at that price instead of being locked or crossed by a quotation on the other side of the market.

## 3. Sub-Penny Rule

The Sub-Penny Rule (reproposed Rule 612 under Regulation NMS) would prohibit market participants from displaying, ranking, or accepting quotations in NMS stocks that are priced in an increment of less than \$0.01, unless the price of the quotation is less than \$1.00. If the price of the quotation is less than \$1.00, the minimum increment would be \$0.0001. A strong consensus of commenters supported the sub-penny proposal as a means to promote greater price

<sup>15</sup> See *infra*, notes 59–61 and accompanying text.

<sup>16</sup> See *infra*, section III.A.1.

<sup>17</sup> Private linkages are discussed further in section III.A.1 below.

<sup>18</sup> The comments on access fees are addressed in section III.A.2 below.

<sup>19</sup> See *infra*, section III.A.2.

transparency and consistency, as well as to protect displayed limit orders.<sup>20</sup> In particular, Rule 612 would address the practice of “stepping ahead” of displayed limit orders by trivial amounts. It therefore should further encourage the display of limit orders and improve the depth and liquidity of trading in NMS stocks.

#### 4. Market Data Rules and Plans

The repropoed amendments to the Market Data Rules (repropoed Rules 601 and 603 under Regulation NMS) and joint industry plans (“Plans”)<sup>21</sup> are designed to promote the wide availability of market data and to allocate revenues to SROs that produce the most useful data for investors. They would strengthen the existing market data system, which provides investors in the U.S. equity markets with real-time access to the best quotations and most recent trades in the thousands of NMS stocks throughout the trading day. For each stock, quotations and trades are continuously collected from many different trading centers and then disseminated to the public in a consolidated stream of data. As a result, investors of all types have access to a reliable source of information for the best prices in NMS stocks. When Congress mandated the creation of the NMS in 1975, it noted that the systems for disseminating consolidated market data would “form the heart of the national market system.”<sup>22</sup> Accordingly, one of the Commission’s most important responsibilities is to preserve the integrity and affordability of the consolidated data stream.

The repropoed amendments would promote this objective in several different respects. First, they would update the formulas for allocating

revenues generated by market data fees to the various SRO participants in the Plans. The current Plan formulas are seriously flawed by an excessive focus on the number of trades, no matter how small the size, reported by an SRO. They thereby create an incentive for distortive behavior, such as wash sales and trade shredding,<sup>23</sup> and fail to reflect an SRO’s contribution to the best displayed quotations in NMS stocks. The repropoed formula would correct these flaws. It also is much less complex than the proposal, primarily because, consistent with the approach of the Trade-Through Rule and Access Rule, the new formula would eliminate any reward for manual quotations. It therefore should promote an allocation of revenues to the various SROs that more closely reflects the usefulness to investors of each SRO’s market information.

The repropoed amendments also are intended to improve the transparency and effective operation of the Plans by broadening participation in Plan governance. They would require the creation of advisory committees composed of non-SRO representatives. Such committees would give interested parties an opportunity to be heard on Plan business, prior to any decision by the Plan operating committees. Finally, the amendments would promote the wide availability of market data by authorizing markets to distribute their own data independently (while still providing their best quotations and trades for consolidated dissemination through the Plans) and streamlining outdated requirements for the display of market data to investors.

Many commenters on the market data proposals expressed frustration with the current operation of the Plans.<sup>24</sup> These commenters generally fell into two groups. One group, primarily made up of individual markets that receive market data fees, believed that the current model of consolidation should be discarded in favor of a new model, such as a “multiple consolidator” model under which each SRO would sell its own data separately. The other group, primarily made up of securities industry participants that pay market data fees, believed that the current level of fees is too high. This group asserted that, prior to modifying the allocation of market data revenues, the Commission should

address the level of fees that generated those revenues.<sup>25</sup>

The Commission has considered these concerns at length in the recent past. As was noted in the Proposing Release,<sup>26</sup> a drawback of the current market data model, which requires all SROs to participate jointly in disseminating data through a single consolidator, is that it affords little opportunity for market forces to determine the overall level of fees or the allocation of those fees to the individual SROs. Prior to publishing the proposals, therefore, the Commission undertook an extended review of the various alternatives for disseminating market data to the public in an effort to identify a better model. These alternatives were discussed at length in the Proposing Release, but each has serious weaknesses. The Commission particularly is concerned that the integrity and reliability of the consolidated data stream must not be compromised by any changes to the market data structure.

For example, although allowing each SRO to sell its data separately to multiple consolidators may appear at first glance to subject the level of fees to competitive forces, this conclusion does not withstand closer scrutiny. If the benefits of a fully consolidated data stream are to be preserved, each consolidator would need to purchase the data of each SRO to assure that the consolidator’s data stream in fact included the best quotations and most recent trade report in an NMS stock. Payment of every SRO’s fees would effectively be mandatory, thereby affording little room for competitive forces to influence the level of fees.

The Commission also has considered the suggestion of many in the second group of commenters that market data fees should be cut back to encompass only the costs of the *Plans* to collect and disseminate market data. Under this approach, the individual SROs would no longer be allowed to fund any portion of their operational and regulatory functions through market data fees.<sup>27</sup> Yet, as discussed in the Commission’s 1999 concept release on

<sup>20</sup> The comments on the sub-penny proposal are discussed in section IV.C below.

<sup>21</sup> The three joint-industry plans are (1) the CTA Plan, which is operated by the Consolidated Tape Association and disseminates transaction information for exchange-listed securities, (2) the CQ Plan, which disseminates consolidated quotation information for exchange-listed securities, and (3) the Nasdaq UTP Plan, which disseminates consolidated transaction and quotation information for Nasdaq-listed securities. The last restatements of the CTA Plan and the CQ Plan were approved in 1996. Securities Exchange Act Release No. 37191 (May 9, 1996), 61 FR 24842 (File No. SR-CTA/CQ-96-1). The amended versions of the CTA Plan and the CQ Plan were filed as attachments to File No. SR-CTA/CQ-96-1, which are available in the Commission’s Public Reference Room. There have been several subsequent amendments to the CTA and CQ Plans; the Plans have not been republished in this connection. The Nasdaq UTP Plan was last published in its entirety in 2004. Securities Exchange Act Release No. 49137 (Jan. 28, 2004), 69 FR 5217 (Feb. 3, 2004).

<sup>22</sup> H.R. Rep. No. 94-229, 94th Cong., 1st Sess. 93 (1975).

<sup>23</sup> Trade shredding, or the splitting of large trades into a series of 100-share trades, is discussed further in section V.A below.

<sup>24</sup> Comments on the market data proposals are discussed in section V.A.2 below.

<sup>25</sup> Some commenters mistakenly believed that the level of market data fees had been left unreviewed for many years. In fact, the Commission comprehensively reviewed market data fees in 1999, which led to a 75% reduction in fees paid by retail investors for market data. See *infra*, note 295.

<sup>26</sup> Proposing Release, 69 FR at 11177.

<sup>27</sup> The U.S. equity markets are not alone in their reliance on market information revenues as a significant source of funding. All of the other major world equity markets currently derive large amounts of revenues from selling market information. See *infra*, note 308 and accompanying text.

market data,<sup>28</sup> nearly the entire burden of collecting and producing market data is borne by the individual markets, not by the Plans. If, for example, an SRO's systems fail on a high-volume trading day and it can no longer provide its data to the Plans, investors will suffer the consequences of a flawed data stream, regardless of whether the Plan is able to continue operating.

If the Commission were to limit market data fees to cover only Plan costs, SRO funding would have been cut by \$386 million in 2003.<sup>29</sup> Given the potential harm if vital SRO functions are not adequately funded, the Commission believes that the level of market data fees is most appropriately addressed in a context that looks at SRO funding as a whole. It therefore has requested comment on this issue in its recent concept release on SRO structure.<sup>30</sup> In addition, the recently proposed rules to improve SRO transparency would, if adopted, assist the public in assessing the level and use of market data fees by the various SROs.<sup>31</sup>

In sum, there is inherent tension between assuring price transparency for investors, which is a fundamental objective of the Exchange Act,<sup>32</sup> and expanding the extent to which market forces determine market data fees and SRO revenues. Each alternative model for data dissemination has its particular strengths and weaknesses. The great strength of the current model, however, is that it benefits investors, particularly retail investors, by helping them to assess quoted prices at the time they place an order and to evaluate the best execution of their orders against such prices by obtaining data from a single source that is highly reliable and comprehensive. In the absence of full confidence that this benefit would be retained if a different model were adopted, the Commission has decided to repropose such immediate steps as are necessary to improve the operation of the current model.

## II. Trade-Through Rule

The Commission is reproposing Rule 611 under Regulation NMS to establish protection against trade-throughs for all NMS stocks. Rule 611(a)(1) would require a trading center (which includes

national securities exchanges, exchange specialists, ATSS, OTC market makers, and block positioners)<sup>33</sup> to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs of protected quotations and, if relying on an exception, that are reasonably designed to assure compliance with the terms of the exception. Rule 611(a)(2) would require a trading center to regularly surveil to ascertain the effectiveness of its policies and procedures and to take prompt action to remedy deficiencies in such policies and procedures. To qualify for protection, a quotation must be automated. Rule 600(b)(3) would define an automated quotation as one that, among other things, is displayed and immediately accessible through automatic execution. Rule 611 would not require market participants to route orders to access any manual quotations, which generally entail a much slower speed of response than automated quotations.

Reproposed Rule 611(b) would set forth a variety of exceptions to make intermarket price protection as efficient and workable as possible. These would include an intermarket sweep exception, which would allow market participants simultaneously to access multiple price levels at different trading centers—a particularly important function now that trading in penny increments has dispersed liquidity across multiple price levels. The intermarket sweep exception would enable trading centers that receive sweep orders to execute those orders immediately, without waiting for better-priced quotations in other markets to be updated. In addition, Rule 611 would provide exceptions for the quotations of trading centers experiencing, among other things, a material delay in providing a response to incoming orders and for flickering quotations with prices that have been displayed for less than one second. Both exceptions are designed to limit the application of Rule 611 to quotations that are truly automated and accessible.

By strengthening price protection in the NMS for quotations that can be accessed fairly and efficiently, repropose Rule 611 is designed to further the interests of both investors

who submit displayed limit orders and investors who submit marketable orders.<sup>34</sup> Price protection encourages the display of limit orders by increasing the likelihood that they will receive an execution in a timely manner. Limit orders typically establish the best prices for an NMS stock. Greater use of limit orders would increase market depth and liquidity, thereby improving the quality of execution for the large market orders of institutional investors. Moreover, strong intermarket price protection would offer greater assurance, on an order-by-order basis, to investors who submit market orders that their orders in fact will be executed at the best prices, which can be difficult for investors, particularly retail investors, to monitor.<sup>35</sup> Finally, market orders would need to be routed only to quotations that are truly accessible.

### A. Response to Comments and Basis for Reproposed Rule

Rule 611 as repropose reflects a number of changes to the rule as proposed. As discussed below, the Commission made these changes in response to substantial public comment on the proposed rule and on the issues arising out of the NMS Hearing that were addressed in the Supplemental Release. The public submitted more than 700 comments addressing the trade-through proposal.<sup>36</sup> Although the comments covered a very wide range of matters, they particularly focused on the following issues:

(1) Whether an intermarket trade-through rule is needed to promote fair

<sup>34</sup> For ease of reference in this release, the term "limit order" generally will refer to a non-marketable order and the term "marketable order" will refer to both market orders and marketable limit orders. A non-marketable limit order has a limit price that prevents its immediate execution at current market prices. Because these orders cannot be executed immediately, they generally are publicly displayed to attract contra side interest at the price. In contrast, a "marketable limit order" has a limit price that potentially allows its immediate execution at current market prices. As discussed further below, marketable limit orders often cannot be filled at current market prices because of insufficient liquidity and depth at the market price. See *infra*, text accompanying note 49.

<sup>35</sup> Investors generally will know the best quoted prices at the time they place an order by referring to the consolidated quotation stream for a stock. In the interval between order submission and order execution, however, quoted prices can change. If the order execution price provided by a market differs from the best quoted price at order submission, it can be particularly difficult for retail investors to assess whether the difference was attributable to changing quoted prices or to an inferior execution by the market. The Trade-Through Rule would help assure, on an order-by-order basis, that markets effect trades at the best available prices.

<sup>36</sup> The Commission has considered the views of all commenters in formulating Rule 611 as repropose, as well as the other rules and amendments repropose today.

<sup>28</sup> Securities Exchange Act Release No. 42208 (Dec. 9, 1999), 64 FR 70613 (Dec. 17, 1999) ("Market Information Release").

<sup>29</sup> See Proposing Release, 69 FR at 11179 (table setting forth revenue allocations for 2003).

<sup>30</sup> Securities Exchange Act Release No. 50700 (Nov. 18, 2004), 69 FR 71256 (Dec. 8, 2004) ("SRO Structure Release").

<sup>31</sup> Securities Exchange Act Release No. 50699 (Nov. 18, 2004), 69 FR 71126 (Dec. 8, 2004) ("SRO Transparency Release").

<sup>32</sup> Section 11A(a)(1)(C)(iii) of the Exchange Act.

<sup>33</sup> An "OTC market maker" in a stock is defined in repropose Rule 600(b)(52) of Regulation NMS as, in general, a dealer that holds itself out as willing to buy and sell the stock, otherwise than on a national securities exchange, in amounts of less than block size (less than 10,000 shares). A block positioner in a stock, in contrast, limits its activity in the stock to transactions of 10,000 shares or greater.

and efficient equity markets, particularly for Nasdaq stocks which have not been subject to the current ITS trade-through provisions;

(2) Whether only automated and immediately accessible quotations should be given trade-through protection and, if so, what is the best approach for defining such quotations;

(3) Whether intermarket protection against trade-throughs can be implemented in a workable manner, particularly for high-volume stocks;

(4) Whether the proposed exception allowing a general opt-out of protected quotations is necessary or appropriate, particularly if manual quotations are excluded from trade-through protection;

(5) Whether the scope of quotations entitled to trade-through protection should extend beyond the best bids and offers of the various markets; and

(6) Whether the benefits of an intermarket trade-through rule would justify its cost of implementation.

In the following sections, the Commission responds to comments on the trade-through proposal and discusses the basis for its reproposal of Rule 611.

### 1. Need for Intermarket Trade-Through Rule

Commenters were divided on the central issue of whether intermarket protection of displayed quotations is needed to promote the fairest and most efficient markets for investors.<sup>37</sup> Many commenters strongly supported the adoption of a uniform rule for all NMS stocks as necessary to protect the best displayed prices and encourage the public display of limit orders.<sup>38</sup> They stressed that limit orders are the cornerstone of efficient, liquid markets

<sup>37</sup> Nearly all commenters, both those supporting and opposing the need for an intermarket trade-through rule, agreed that the current ITS trade-through provisions are seriously outdated and in need of reform. They particularly focused on the problems created by affording equal protection against trade-throughs to both automated and manual quotations. Reproposed Rule 611 responds to these problems by protecting only automated quotations.

<sup>38</sup> Approximately 138 commenters favored a trade-through rule that did not include an exception allowing market participants to opt-out of the rule. Commenters in this group included (1) many mutual fund companies and the Investment Company Institute; (2) approximately 24 individual investors and the Consumer Federation of America and the National Association of Individual Investors Corporation, (3) floor-based exchanges and their members, (4) approximately 29 listed companies, (5) a variety of securities industry participants, and (6) 12 members of Congress. In addition, many commenters supported an opt-out exception to a trade-through rule, but varied in the extent to which they made clear whether they supported a trade-through rule in general. These commenters are included in footnote 99 below addressing supporters of an opt-out exception.

and should be afforded as much protection as possible. They noted, for example, that limit orders typically establish the "market" for a stock. In the absence of limit orders setting the current market price, there would be no benchmark for the submission and execution of marketable orders.

Focusing solely on best execution of marketable orders (and the interests of orders that take displayed liquidity), therefore, would miss a critical part of the equation for promoting the most efficient markets (*i.e.*, the best execution of orders that *supply* displayed liquidity and thereby provide public price discovery). Commenters supporting the need for an intermarket trade-through rule also believed that a trade-through rule would increase investor confidence by helping to eliminate the impression of unfairness when an investor's order executes at a price that is worse than the best displayed quotation, or when a trade occurs at a price that is inferior to the investor's displayed order.<sup>39</sup>

Other commenters, in contrast, opposed any intermarket trade-through rule.<sup>40</sup> These commenters did not believe that such a rule is necessary to promote the protection of limit orders, the best execution of market orders, or efficient markets in general. They asserted that, given public availability of each market's quotations and ready access by all market participants to such quotations, competition among markets, a broker's existing duty of best execution, and economic self-interest would be sufficient to protect limit orders and produce the most fair and efficient markets. They therefore believed that any trade-through rule would be unnecessary and costly. These commenters also were concerned that any trade-through rule could interfere with the ability of competitive forces to produce efficient markets, particularly for Nasdaq stocks.

Commenters opposed to any trade-through rule also generally cited a lack

<sup>39</sup> *See, e.g.*, Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, to Jonathan G. Katz, Secretary, Commission, dated June 17, 2004 ("Consumer Federation Letter") at 2; Letter from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 ("ICI Letter") at 7.

<sup>40</sup> Approximately 242 commenters opposed any trade-through rule. Approximately 179 of these commenters utilized "Letter Type C," which primarily supported an opt-out exception to the proposed rule, but also suggested that no trade-through rule would be simpler. Letter Type C is posted on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). The remaining commenters included securities industry participants, particularly electronic markets and their participants, a variety of local political and community groups and individuals, and 17 members of Congress.

of empirical evidence justifying the need for intermarket protection against trade-throughs. They noted, for example, that trading in Nasdaq stocks has never been subject to an intermarket trade-through rule, while trading in exchange-listed stocks, particularly NYSE stocks, has been subject to the ITS trade-through provisions. Given the difference in regulatory requirements between Nasdaq and NYSE stocks, many commenters relied on two factual contentions to show that a trade-through rule is not needed: (1) Trading in Nasdaq stocks currently is more efficient than trading in NYSE stocks;<sup>41</sup> and (2) fewer trade-throughs occur in Nasdaq stocks than NYSE stocks.<sup>42</sup> Based on these factual contentions, opposing commenters concluded that a trade-through rule is not necessary to promote efficiency or to protect the best displayed prices.

A few commenters submitted empirical data to support the claim that trading in Nasdaq stocks is more efficient than trading in NYSE stocks.<sup>43</sup>

<sup>41</sup> *See, e.g.*, Letter from Ellen L.S. Koplou, Executive Vice President and General Counsel, Ameritrade Holding Corporation, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 ("Ameritrade Letter I"), Appendix at 10; Letter from William O'Brien, Chief Operating Officer, Brut LLC, to Jonathan G. Katz, Secretary, Commission, dated July 29, 2004 ("Brut Letter") at 10; Letter from Eric D. Roiter, Senior Vice President & General Counsel, Fidelity Management and Research Company, to Jonathan G. Katz, Secretary, Commission, dated June 22, 2004 ("Fidelity Letter I") at 11; Letter from Edward J. Nicoll, Chief Executive Officer, Instinet Group Incorporated, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 ("Instinet Letter") at 3, 9 & Exhibit A; Letter from Edward S. Knight, The Nasdaq Stock Market, Inc., to Jonathan G. Katz, Secretary, Commission, dated July 2, 2004 ("Nasdaq Letter II") at 6 and Attachment II; Letter from Bruce N. Lehmann & Joel Hasbrouck, Organizers, Reg NMS Study Group, to Jonathan G. Katz, Secretary, Commission (no date) ("NMS Study Group Letter") at 4; Letter from David Colker, Chief Executive Officer & President, National Stock Exchange, to Jonathan G. Katz, Secretary, Commission, dated June 29, 2004 ("NSX Letter") at 3; Letter from Huw Jenkins, Managing Director, Head of Equities for the Americas, UBS Securities LLC, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 ("UBS Letter") at 4.

<sup>42</sup> *See, e.g.*, Letter from Kim Bang, President & Chief Executive Officer, Bloomberg Tradebook LLC, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 ("Bloomberg Tradebook Letter") at 10; Fidelity Letter I at 11; Letter from Suhas Daftuar, Managing Director, Hudson River Trading, to Jonathan G. Katz, Secretary, Commission, dated August 13, 2004 ("Hudson River Trading Letter") at 1; Instinet Letter at 14; Nasdaq Letter II at 6 and Attachment III.

<sup>43</sup> Instinet Letter, Exhibit A; Nasdaq Letter II, Attachment II. The Mercatus Center referenced several statistical studies in its comment letter and concluded that the findings of such studies are mixed. Letter from Susan E. Dudley, Director, Regulatory Studies Program, Mercatus Center, George Mason University, to Jonathan G. Katz, Secretary, Commission, dated May 24, 2004 ("Mercatus Center Letter") at 3.



Specifically, they submitted tables asserting that effective spreads in Nasdaq stocks in the S&P 500 are significantly narrower than effective spreads in NYSE stocks in the S&P 500.<sup>44</sup> To help assess and respond to the views of commenters on market efficiency, the Commission staff analyzed Rule 11Ac1-5 reports and other trading data to evaluate the markets for Nasdaq and NYSE stocks.<sup>45</sup> The staff studies indicate that the execution quality statistics submitted by commenters are flawed. The claimed large and systematic disparities between Nasdaq and NYSE effective spreads disappear when an analysis of execution quality more appropriately controls for differences in stocks, order types, and order sizes.<sup>46</sup> The staff studies reveal that both the market for Nasdaq stocks and the market for NYSE stocks have significant strengths. But, as discussed below, both markets also have weaknesses that could be reduced by strengthened protection against trade-throughs.

First, the effective spread analyses submitted by commenters do not, in a number of respects, reflect appropriately the comparative trading costs in Nasdaq and NYSE stocks.<sup>47</sup> They were

<sup>44</sup> Nasdaq and Instinet based their tables on statistics derived from the reports ("Dash 5 Reports") on order execution quality made public by markets pursuant to Exchange Act Rule 11Ac1-5 (proposed to be redesignated as Rule 605 under Regulation NMS). Their source for these reports is Market Systems, Inc. ("MSI"), a private vendor that collects the reports of all markets each month and includes them in a searchable database. MSI also is the source of the Dash 5 Reports used in the staff analyses.

<sup>45</sup> Memorandum to File, from Office of Economic Analysis, dated December 15, 2004 (comparative analysis of execution quality for NYSE and NASDAQ stocks based on a matched sample of stocks) ("Matched Pairs Study"); Memorandum to File, from Division of Market Regulation, dated December 15, 2004 (comparative analysis of Rule 11Ac1-5 statistics by S&P Index) ("S&P Index Study"). The Matched Pairs Study and S&P Index Study have been placed in Public File No. S7-10-04 and are available for inspection on the Commission's Internet Web site (<http://www.sec.gov>).

<sup>46</sup> Matched Pairs Study, Tables 4-10; S&P Index Study, Tables 2-9.

<sup>47</sup> The effective spread is a useful measure of trading costs, particularly for small order sizes, because it reflects the prices actually received by investors when compared to the best quotes at the time a market received an order. Consequently, unlike the quoted spread, the effective spread reflects any cost to investors caused by movement in prices during a delay between receipt of an order and execution of an order. In other words, the effective spread penalizes slow markets for failing to execute trades at their quoted prices at the time they received an order. It therefore provides an appropriate criterion with which to compare execution quality between automated and manual markets for comparable stocks, order types, and order sizes. As discussed below, however, effective spread statistics do not capture trading costs that are attributable to low fill rates—the failure to obtain an execution—for marketable limit orders.

presented in terms of "cents-per-share" and therefore failed to control for the varying level of stock prices between Nasdaq stocks and NYSE stocks in the S&P 500. Lower priced stocks naturally will tend to have lower spreads in terms of cents-per-share than higher priced stocks, even when such cents-per-share spreads constitute a larger percentage of stock price and therefore represent trading costs for investors that consume a larger percentage of their investment. By using cents-per-share statistics, commenters did not adjust for the fact that the average prices of Nasdaq stocks are significantly lower than the average prices of NYSE stocks. For example, the average price of Nasdaq stocks in the S&P 500 in January 2004 was \$34.14, while the average price of NYSE stocks was \$41.32.<sup>48</sup>

The effective spread analyses submitted by commenters also were weakened by their failure to address the much lower fill rates of orders in Nasdaq stocks than orders in NYSE stocks. The commenters submitted "blended" statistics that encompassed both market orders and marketable limit orders. The effective spread statistics for these order types are not comparable, however, because market orders do not have a limit price that precludes their execution at prices inferior to the prevailing market price at time of order receipt. In contrast, the limit price of marketable limit orders often precludes an execution, particularly when there is a lack of liquidity and depth at the prevailing market price. For example, the fill rates for marketable limit orders in Nasdaq stocks generally are less than 75%, and often fall below 50% for larger order sizes.<sup>49</sup>

Accordingly, investors must accept trade-offs when deciding whether to submit market orders or marketable limit orders (particularly when the limit price equals or is very close to the current market price). Use of a limit price generally assures a narrower spread by precluding an execution at an inferior price. By precluding an execution, however, the limit price may cause the investor to "miss the market" if prices move away (for example, if prices rise when an investor is attempting to buy). Effective spreads for marketable limit orders therefore represent trading costs that are conditional on execution, while effective spreads for market orders much more completely reflect the entire trading cost for a particular order. Market orders represent only

<sup>48</sup> S&P Index Study, Table 1.

<sup>49</sup> Matched Pairs Study, Table 10; S&P Index Study, Tables 7, 9.

approximately 14% of the blended flow of market and marketable limit orders in Nasdaq stocks (reflecting the fact that ECNs now dominate Nasdaq order flow and limit orders represent the vast majority of ECN order flow).<sup>50</sup> In contrast, market orders represent approximately 36% of the blended order flow in NYSE stocks.<sup>51</sup> Accordingly, the effective spread statistics for marketable limit orders, and particularly for orders in Nasdaq stocks, must be considered in conjunction with the fill rate for such orders—a narrow spread is good, but the benefits are greatly limited if investors are unable to obtain an execution at that spread. The analyses presented by the commenters, however, did not address the respective fill rates for Nasdaq stocks and NYSE stocks or reflect the inherent differences in measuring the trading costs of market orders and marketable limit orders.

The analyses prepared by Commission staff are designed to provide appropriate evaluations of comments on the efficiency of trading in Nasdaq and NYSE stocks. In particular, they are more finely tuned to evaluate trading for different types of stocks with varying trading volume, different types of orders, and different sizes of orders. These analyses indicate that the markets for Nasdaq and NYSE stocks each have weaknesses that an intermarket price protection rule could help address. For example, the effective spread statistics for large, electronically-received market orders in NYSE stocks show significant "slippage"—the amount by which orders are executed at prices inferior to the national best bid or offer ("NBBO") at the time of order receipt.<sup>52</sup> Slippage often results in effective spreads for large orders that are many times wider than the effective spreads for small orders in the same NYSE stocks. By protecting automated quotations, the re-proposed Trade-Through Rule should enhance the depth and liquidity available for large, electronic orders in NYSE stocks.

For Nasdaq stocks, the Rule 11Ac1-5 statistics reveal very low fill rates for larger sizes of marketable limit orders (e.g., 2000 shares or more), which generally fall below 50% for most Nasdaq stocks. Contrary to the assertion of some commenters,<sup>53</sup> certainty of

<sup>50</sup> An overwhelming majority of market orders in Nasdaq stocks are executed by market-making dealers pursuant to agreement with their correspondent or affiliated brokers.

<sup>51</sup> Matched Pairs Study at 1.

<sup>52</sup> Matched Pairs Study, Tables 4, 7; S&P Index Study, Tables 2, 4, 6, 8.

<sup>53</sup> See, e.g., Instinet Letter at 9; Nasdaq Letter II at 6. In addition to effective spread statistics, Instinet submitted statistics indicating that

execution clearly is not a strength of the current market for Nasdaq stocks. Certainty of a fast response is a strength, but much of the time the response to large orders will be a “no fill” at any given trading center. The repropoed Trade-Through Rule is designed to enhance depth and liquidity and thereby improve the execution quality of large orders in Nasdaq stocks.<sup>54</sup>

Effective spread statistics do not, of course, reflect all types of trading costs. They focus on the execution price of individual orders in comparison with the best quoted prices at the time orders are received. As a result, they do not capture trading costs that are associated with the short-term movement of quoted prices, or volatility. To further assist the Commission in evaluating the views of commenters, Commission staff also has analyzed short-term volatility for trading in Nasdaq and NYSE stocks.<sup>55</sup> This analysis particularly focuses on transitory volatility—short-term fluctuations away from the fundamental or “true” value of a stock. Transitory volatility should be distinguished from fundamental volatility—price fluctuations associated with factors independent of market structure, such as earnings changes and other economic determinants of stock prices. The staff analysis found that transitory volatility is significantly higher for Nasdaq stocks than for NYSE stocks.<sup>56</sup> Excessive transitory volatility indicates a shortage of liquidity. Such volatility may provide benefits in the form of profitable trading opportunities for short-term traders or market makers, but these benefits come at the expense of other investors, who

combined market and marketable limit orders in Nasdaq stocks were more likely to be executed at or inside the NBBO than such orders in NYSE stocks. Instinet Letter, Table I–C. These statistics, however, only reflect orders that in fact receive an execution—not the large volume of orders in Nasdaq stocks that fail to receive any execution at all.

<sup>54</sup> Some commenters asserted that the large number of limit orders in Nasdaq stocks indicates that sufficient incentives exist for the placement of limit orders in such stocks. *See, e.g.*, Instinet Letter at 11; Letter from Thomas N. McManus, Managing Director & Counsel, Morgan Stanley & Co. Incorporated, to Jonathan G. Katz, Secretary, Commission, dated August 19, 2004 (“Morgan Stanley Letter”) at 14. Strengthened intermarket trade-through protection, however, is designed to improve the quality of limit orders in a stock, particularly their displayed size, and thereby promote greater depth and liquidity. This goal is not achieved, for example, by a large number of limit orders with small sizes and high cancellation rates.

<sup>55</sup> Memorandum to File, from Office of Economic Analysis, dated December 15, 2004 (analysis of volatility for stocks switching from NASDAQ to NYSE) (“Volatility Study”). The Volatility Study has been placed in Public File No. S7–10–04 and is available for inspection on the Commission’s Internet Web site (<http://www.sec.gov>).

<sup>56</sup> Volatility Study at 1.

would be buying at artificially high or selling at artificially low prices. Retail investors, in particular, tend to be relatively uninformed concerning short-term price movements and are apt to bear the brunt of the trading costs associated with excessive transitory volatility. The repropoed Trade-Through Rule, by promoting greater depth and liquidity, is designed to help reduce excessive transitory volatility in Nasdaq stocks.

The second principal factual contention of commenters opposed to a trade-through rule is premised on the claim that there are fewer trade-throughs in Nasdaq stocks, which are not covered by any trade-through rule, than in NYSE stocks, which are covered by the ITS trade-through provisions.<sup>57</sup> One commenter asserted that, outside the exchange-listed markets, competition alone had been sufficient to create a “no-trade through zone.”<sup>58</sup> To respond to these claims, the Commissions staff examined public quotation and trade data to analyze the incidence of trade-throughs for Nasdaq and NYSE stocks.<sup>59</sup> It found that the overall trade-through rates for Nasdaq stocks and NYSE stocks were, respectively, 7.9% and 7.2% of the total volume of traded shares.<sup>60</sup> When considered as a percentage of number of trades, the overall trade-throughs rate for both Nasdaq and NYSE stocks was 2.5%. In addition, the staff analysis found that the amount of the trade-throughs was significant—2.3 cents per share on average for Nasdaq stocks and 2.2 cents per share for NYSE stocks.<sup>61</sup>

<sup>57</sup> *See, e.g.*, Bloomberg Tradebook Letter at 10; Fidelity Letter I at 11; Hudson River Trading Letter at 1; Instinet Letter at 14; Nasdaq Letter II at 6 and Attachment III.

<sup>58</sup> Letter from Kevin J. P. O’Hara, Chief Administrative Officer & General Counsel, Archipelago Holdings, Inc., to Jonathan G. Katz, Secretary, Commission, dated September 24, 2004 (“ArcaEx Letter”) at 3.

<sup>59</sup> Memorandum to File, from Office of Economic Analysis, dated December 15, 2004 (analysis of trade-throughs in Nasdaq and NYSE issues) (“Trade-Through Study”). The Trade-Through Study has been placed in Public File No. S7–10–04 and is available for inspection on the Commission’s Internet Web site (<http://www.sec.gov>). To eliminate false trade-throughs, the staff calculated trade-through rates using a 3-second window—a reference price must have been displayed one second before a trade and still have been displayed one second after a trade. In addition, the staff eliminated quotations displayed by the American Stock Exchange LLC (“Amex”) from the analysis of Nasdaq stocks because they were manual quotations. Finally, the staff used the time of execution of a trade, if one was given, rather than time of the trade report itself. This methodology was designed to eliminate manual trades, such as block trades, that might not be reported for several seconds after the trade was effected manually.

<sup>60</sup> Trade-Through Study, Tables 4, 11.

<sup>61</sup> *Id.*, Tables 3, 10.

The staff analysis also revealed that a large volume of block transactions (10,000 shares or greater) trade through displayed quotations. Block transactions represent approximately 50% of total trade-through volume for both Nasdaq and NYSE stocks.<sup>62</sup> Importantly, many block transactions currently are not subject to the ITS trade-through provisions that apply to exchange-listed stocks. Broker-dealers that act solely as block positioners are not covered by the ITS trade-through provisions if they print their trades in the over-the-counter (“OTC”) market. In addition to not covering the trades of block positioners, the ITS trade-through provisions include an exception for 100-share quotations. They therefore often may fail to protect the small orders of retail investors. When block trade-throughs and trade-throughs of 100-share quotations are eliminated, the overall trade-through rate for NYSE stocks is reduced from 7.2% to approximately 2.3% of total share volume.<sup>63</sup> The two gaps in ITS coverage therefore account for most of the trade-through volume in NYSE stocks. The repropoed Trade-Through Rule, by closing these gaps in protection against trade-throughs, would establish much stronger price protection than the ITS provisions.

In sum, relevant data supports the need for an intermarket rule to strengthen price protection and improve the quality of trading in both Nasdaq and exchange-listed stocks. The arguments of some commenters that competitive forces alone are sufficient to achieve these objectives fail to take into account two structural problems—principal/agent conflicts of interest and “free-riding” on displayed prices.

Agency conflicts occur when brokers may have incentives to act otherwise than in the best interest of their customers. Customers, particularly retail investors, may have difficulty monitoring whether their individual orders miss the best displayed prices at the time they are executed.<sup>64</sup> Given the large number of trades that fail to obtain the best displayed prices (*e.g.*, approximately 1 in 40 trades for both Nasdaq and NYSE stocks, or approximately 98,000 trades per day in Nasdaq stocks),<sup>65</sup> the Commission is

<sup>62</sup> *Id.*, Tables 4, 11.

<sup>63</sup> *Id.*, Table 11.

<sup>64</sup> *See supra*, note 35 (discussion of difficulty for investors to monitor whether their order execution prices equal the best quoted prices at the time of order execution).

<sup>65</sup> In October 2004, there were 3.9 million average daily trades reported in Nasdaq stocks. Source: <http://www.nasdaqtrader.com>. The average trade-through rate of 2.5% for Nasdaq stocks yields

Continued

concerned that many of the investors that ultimately received the inferior price on these trades may not be aware that their orders did not, in fact, obtain the best price. The reproposed Trade-Through Rule would backstop a broker's duty of best execution by prohibiting the practice of executing orders at inferior prices, absent an applicable exception.

Just as importantly, even when market participants act in their own economic self-interest, or brokers act in the best interests of their customers, they may deliberately choose, for various reasons, to bypass (*i.e.*, not protect) limit orders with the best displayed prices. For example, an institution may be willing to accept a dealer's execution of a particular block order at a price outside the NBBO, thereby transferring the risk of any further price impact to the dealer. Market participants that execute orders at inferior prices without protecting displayed limit orders are effectively "free-riding" on the price discovery provided by those limit orders. Displayed limit orders benefit all market participants by establishing the best prices, but, when bypassed, do not themselves receive a benefit, in the form of an execution, for providing this public good. This economic externality, in turn, creates a disincentive for investors to display limit orders, particularly limit orders of any substantial size.

As demonstrated by the current rate of trade-throughs of the best quotations in Nasdaq and NYSE stocks, these structural problems often can lead to executions at prices that are inferior to displayed quotations, meaning that limit orders are being bypassed. The frequent bypassing of limit orders can cause fewer limit orders to be placed. The Commission therefore preliminarily believes that the reproposed Trade-Through Rule is needed to encourage greater use of limit orders. The more limit orders available at better prices and greater size, the more liquidity available to fill incoming marketable orders. Increased liquidity, in turn, could lead market participants to interact more often with displayed orders, which would lead to greater use of limit orders, and thus begin the cycle again. The end result should be an NMS that more fully meets the needs of a broad spectrum of investors, particularly the long-term investors, as opposed to short-term traders, that benefit most from improved market depth and liquidity.

## 2. Limiting Protection to Automated and Accessible Quotations

The trade-through proposal sought to strengthen protection against trade-throughs, while also addressing problems posed by the inherent differences in quotations displayed by automated markets, which are immediately accessible, and quotations displayed by manual markets, which are not. The proposal included an exception that would have allowed automated markets to trade through manual markets, but only up to certain amounts that varied depending upon the price of the security. Under the proposal, a market would be classified as "manual" if it did not provide for an immediate automated response to *all* incoming orders attempting to access its displayed quotations.<sup>66</sup>

At the NMS Hearing, a significant portion of the discussion of the trade-through proposal addressed issues relating to quotations of automated and manual markets. Representatives of two floor-based exchanges announced their intent to establish "hybrid" trading facilities that would offer automatic execution of orders seeking to interact with their displayed quotations, while at the same time maintaining a traditional floor.<sup>67</sup> These representatives acknowledged the difficulties posed in developing an efficient hybrid market, but emphasized that they were committed to developing such facilities and that such facilities were likely to become operational prior to any implementation of Regulation NMS.

Other panelists at the NMS Hearing strongly believed that manual quotations should not receive any protection against trade-throughs and that the proposed trade-through amounts should be eliminated.<sup>68</sup> They noted, however, that existing order routing technologies are capable of identifying, on a quote-by-quote basis, indications from a market that a particular quotation is not immediately and automatically accessible (*i.e.*, is a manual quotation). Using this functionality, a trade-through rule could classify individual quotations as automated or manual, rather than classifying an entire market as manual solely because it displayed manual quotations on occasion.

To give the public a full opportunity to comment on these issues, the Supplemental Release described the developments at the NMS Hearing and requested comment on whether a trade-through rule should protect only

automated quotations and whether the rule should adopt a "quote-by-quote" approach to identifying protected quotations.<sup>69</sup> The Supplemental Release also requested comment on the requirements for an automated quotation, including whether the rule should impose a maximum response time, such as one second, on the total time for a market to respond to an order in an automated manner. Comment also was requested on mechanisms for enforcing compliance with the automated quotation requirements.

Nearly all commenters believed that only automated quotations should receive protection against trade-throughs and that therefore the proposed limitation on trade-through amounts for manual markets should be eliminated.<sup>70</sup> The Commission agrees. The reproposed Trade-Through Rule would protect only those quotations that are immediately and automatically accessible. Providing protection to manual quotations, even limited to trade-throughs beyond a certain amount, potentially would lead to undue delays in the routing of investor orders, thereby outweighing the benefits of price protection. If the Trade-Through Rule were adopted, investors would have the choice of whether to access a manual quotation and wait for a response or to access an automated quotation with an inferior price and obtain an immediate response. Moreover, those who route limit orders would be able to control whether their orders are protected by evaluating the extent to which various trading centers display automated versus manual quotations.

Commenters expressed differing views, however, on the appropriate standards for automated quotations and on the standards that should govern "hybrid" markets—those that display both automated and manual quotations. These issues are discussed below.

a. Standards for Automated Quotations. Nearly all commenters addressing the issue believed that only quotations that are truly firm and fully accessible should qualify as "automated."<sup>71</sup> To achieve this goal,

<sup>69</sup> Supplemental Release, 69 FR at 30142–30144.

<sup>70</sup> See, e.g., Ameritrade Letter I at 8; Letter from Lou Klobuchar Jr., President and Chief Brokerage Officer, E\*TRADE Financial Corporation, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 ("E\*Trade Letter") at 6; ICI Letter at 12; Nasdaq Letter II at 9, 14; Letter from Marc Lackritz, President, Securities Industry Association, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 ("SIA Letter") at 15.

<sup>71</sup> See, e.g., Letter from John J. Wheeler, Vice President, Director of U.S. Equity Trading, American Century Investment Management Inc., to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 ("American Century Letter") at 3;

average daily trade-throughs of approximately 98,000.

<sup>66</sup> Proposing Release, 69 FR at 11140.

<sup>67</sup> Hearing Tr. at 90–92, 94–97, 120.

<sup>68</sup> Hearing Tr. at 57–58, 67, 142–144, 157–158.

they suggested that, at a minimum, the market displaying an automated quotation should be required to provide a functionality for an incoming order to receive an immediate and automated (*i.e.*, without human intervention) execution up to the full displayed size of the quotation. In addition, they believed the market should provide an immediate and automated response to the sender of the order indicating whether the order had been executed (in full or in part) and an immediate and automated updating of the quotation. A number of commenters advocated a specific time standard for distinguishing between manual and automated quotations, ranging from one second down to 250 milliseconds.<sup>72</sup> Other commenters did not believe the definition of automated quotation should include a specific time standard, generally because setting a specific standard might discourage innovation and become a “ceiling” on market performance.<sup>73</sup>

Letter from C. Thomas Richardson, Citigroup Global Markets, Inc., to Jonathan G. Katz, Secretary, Commission, dated July 20, 2004 (“Citigroup Letter”) at 6–7; Letter from Gary Cohn, Managing Director, Goldman, Sachs & Co., to Jonathan G. Katz, Secretary, Commission, dated July 19, 2004 (“Goldman Sachs Letter”) at 4–5; ICI Letter at 13; Morgan Stanley Letter at 7; SIA Letter at 6.

<sup>72</sup> See, e.g., Ameritrade Letter I at 6; Bloomberg Tradebook Letter at 13; Letter from Kenneth R. Leibler, Chairman, Boston Stock Exchange, Inc., to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 (“BSE Letter”) at 7; Consumer Federation Letter at 3; Letter from David A. Herron, Chief Executive Officer, Chicago Stock Exchange, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 (“CHX Letter”) at 7–8; Citigroup Letter at 7; Goldman Sachs Letter at 2; ICI Letter at 3, 10; Nasdaq Letter II at 3, 13; Letter from John Martello, Managing Director, Tower Research Capital LLC, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 (“Tower Research Letter”) at 5.

<sup>73</sup> See, e.g., American Century Letter at 3, Letter from Salvatore F. Sodano, Chairman & Chief Executive Officer, American Stock Exchange LLC, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 (“Amex Letter”), Exhibit A at 6; Brut Letter at 7; Letter from Matt D. Lyons, Capital Research and Management Company, to Jonathan G. Katz, Secretary, Commission, dated June 28, 2004 (“Capital Research Letter”) at 2; Fidelity Letter I at 8; Instinet Letter at 4; Letter from John H. Bluber, Executive Vice President & General Counsel, Knight Trading Group, to William H. Donaldson, Chairman, Commission, dated April 15, 2004 (“Knight Letter”) at 5; Letter from James T. Brett, J.P. Morgan Securities Inc., to Jonathan G. Katz, Secretary, Commission, dated July 8, 2004 (“JP Morgan Letter”) at 3; Morgan Stanley Letter at 7; Letter from Darla C. Stuckey, Corporate Secretary, New York Stock Exchange, Inc., to Jonathan G. Katz, Secretary, Commission, dated July 2, 2004 (“NYSE Letter”), Attachment at 3; Letter from David Humphreville, President, The Specialist Association, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 (“Specialist Assoc. Letter”) at 8; Letter from Lisa M. Utasi, President, *et al.*, The Security Traders Association of New York, Inc., to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 (“STANY Letter”) at 4; Letter from George U. Sauter, Managing

The Commission has included in the reproposal a definition of automated quotation that incorporates the three elements suggested by commenters: (1) Acting on an incoming order, (2) responding to the sender of the order, and (3) updating the quotation. In particular, repropose Rule 600(b)(3) would require that the trading center displaying an automated quotation must provide an “immediate-or-cancel” (“IOC”) functionality for an incoming order to execute immediately and automatically against the quotation up to its full size, and for any unexecuted portion of such incoming order to be cancelled immediately and automatically without being routed elsewhere. The trading center also must immediately and automatically respond to the sender of an IOC order. To qualify as “automatic,” no human discretion exercised after the time an order is received would be permissible in determining any action taken with respect to an order. Trading centers would be required to offer this IOC functionality only to customers that request immediate action and response by submitting an IOC order. Customers therefore would have the choice of whether to require an immediate response from the trading center, or to allow the market to take further action on the order (such as by routing the order elsewhere, seeking additional liquidity for the order, or displaying the order). Finally, trading centers would be required to immediately and automatically update their automated quotations to reflect any change to their material terms (such as a change in price, size, or “automated” status).

The definition of automated quotation does not set forth a specific time standard for responding to an incoming order. The Commission agrees with commenters that the standard should simply be “immediate”—*i.e.*, a trading center’s systems should provide the fastest response possible without any programmed delay. Nevertheless, the Commission also is concerned that trading centers with well-functioning systems should not be unnecessarily slowed down waiting for responses from a trading center that is experiencing a systems problem. Consequently, rather than fixing a specific time standard that may become obsolete as systems improve over time, Rule 611(b)(1) would address the problem of slow trading centers by providing an exception for quotations displayed by trading centers that are experiencing,

Director, The Vanguard Group, Inc., to Jonathan G. Katz, Secretary, Commission, dated July 14, 2004 (“Vanguard Letter”) at 4.

among other things, a material delay in responding to incoming orders. Given current industry conditions, the Commission believes that repeatedly failing to respond within one second after receipt of an order would constitute a material delay.<sup>74</sup> Accordingly, a trading center would act reasonably in the current trading environment if it bypassed the quotations of another trading center that had repeatedly failed to respond to orders within a one-second time frame (after adjusting for any potential delays in transmission not attributable to the other trading center).<sup>75</sup> This “self-help” remedy, discussed further in sections II.A.3 and II.B.3 below, would give trading centers needed flexibility to deal with a trading center that is experiencing systems problems, rather than forcing smoothly-functioning trading centers to slow down for a problem market.

b. Standards for Automated Trading Centers. The trade-through proposal would have classified a market as manual if it did not provide automated access to *all* orders seeking access to its displayed quotations. Many commenters responded positively to the concept of allowing hybrid markets to display both automated and manual quotations that was raised at the NMS Hearing and discussed in the Supplemental Release. Most national securities exchanges believed that focusing on whether individual quotations are automated or manual would permit hybrid markets to function, thereby expanding the range of trading choices for investors.<sup>76</sup> For example, Amex stated that hybrid markets would offer investors the choice to utilize auction markets when advantageous for them to do so, while at the same time offering automatic execution to those investors desiring speed and certainty of a fast response.<sup>77</sup> A majority of other commenters also believed that the application of any trade-through rule should depend on whether a particular quotation is

<sup>74</sup> Cf. Ameritrade Letter I at 6 (one second response time is appropriate); CHX Letter at 8 (receive, execute, and report back within one second); Citigroup Letter at 7 (turnaround time of no more than one second); Goldman Sachs Letter at 4 (orders executed or cancelled within not more than one second).

<sup>75</sup> As discussed further in section II.B.3 below, a trading center utilizing the material delay exception would be required to establish specific and objective parameters for its use of the exception in its policies and procedures.

<sup>76</sup> See, e.g., Amex Letter at 5; Letter from William J. Brodsky, Chairman & Chief Executive Officer, Chicago Board Options Exchange, Inc., to Jonathan G. Katz, Secretary, Commission, dated July 1, 2004 (“CBOE Letter”) at 3; CHX Letter at 7; NYSE Letter at 4.

<sup>77</sup> Amex Letter, Appendix A at 4.

automated.<sup>78</sup> They believed that such a rule would achieve the benefits of encouraging limit orders and improving market depth and liquidity, while avoiding indirectly mandating a particular market structure.

Although generally supportive of the concept of hybrid markets, several commenters expressed concern about how the "quote-by-quote" approach to protected quotations would operate in practice.<sup>79</sup> The ICI noted that "[w]e are concerned that if it is left completely up to an individual market's discretion when a quote is 'automated' or manual, that market could base its decision on what is in the best interests of that market and its members, as opposed to the best interests of investors and other market participants."<sup>80</sup> These commenters suggested that the Commission should provide clear guidelines as to when and how a market could switch its quotations from automated to manual, and vice versa, so as to prevent abuse by the market.

After considering the views of commenters, the Commission has decided to include in the reproposal an approach that would offer flexibility for a hybrid market to display both automated and manual quotations, but only when such a market meets basic standards that promote fair and efficient access by the public to the market's automated quotations. This approach is designed to allow markets to offer a variety of trading choices to investors, but without requiring other markets and market participants to route orders to a hybrid market with quotations that are not truly accessible. Reproposed Rule 600(b)(4) therefore sets forth requirements for a trading center to qualify as an "automated trading center." Unless a trading center met these requirements, none of its quotations could qualify as automated, and therefore protected, quotations.

To qualify as an automated trading center, the trading center must have implemented such systems and rules as are necessary to render it capable of displaying quotations that meet the action, response, and updating requirements set forth in the definition of an automated quotation. Further, the trading center must identify all quotations other than automated

quotations as manual quotations, and must immediately identify its quotations as manual quotations whenever it has reason to believe that it is not capable of displaying automated quotations. These requirements are designed to enable other trading centers readily to determine whether a particular quotation displayed by a hybrid trading center is protected by the repropose Trade-Through Rule. Finally, an automated trading center must adopt reasonable standards limiting when its quotations change from automated quotations to manual quotations, and vice versa, to specifically defined circumstances that promote fair and efficient access to its automated quotations and are consistent with the maintenance of fair and orderly markets.

These requirements are designed to promote efficient interaction between a hybrid market and other trading centers. The requirement that automated quotations cannot be switched on and off except in specifically defined circumstances is particularly intended to assure that hybrid markets do not give their members, or anyone else, overbroad discretion to control the automated or manual status of the trading center's quotations, which potentially could disadvantage less favorably situated market participants. Changes from automated to manual quotations, and vice versa, must be subject to specific, enforceable limitations as to the timing of switches. For a trading center to qualify as entitled to display any protected quotations, the public in general must have fair and efficient access to a trading center's quotations.

### 3. Workable Implementation of Intermarket Trade-Through Protection

Several commenters expressed concern that the proposed trade-through rule could not be implemented in a workable manner, particularly for high-volume stocks.<sup>81</sup> Morgan Stanley, for example, asserted that an inefficient trading center might have inferior systems that would delay routed orders and potentially diminish their quality of execution.<sup>82</sup> Instinet emphasized that protecting a market's quotations "confers enormous power on a market \* \* \* Such power can and will be abused either directly (e.g., by quoting slower than executing orders) or

indirectly (e.g., not investing in more than minimum system capacity or redundancy)."<sup>83</sup> Hudson River Trading noted that markets sometimes experience temporary systems problems and questioned how a trade-through rule would handle these scenarios.<sup>84</sup> Nasdaq observed that quotations in many Nasdaq stocks are updated more than two times per second. It said that these frequent changes could lead to many false indications of trade-throughs and that eliminating these "false positives" would greatly reduce the percentage of transactions subject to a trade-through rule.<sup>85</sup> Finally, many commenters noted that market participants need the ability to sweep multiple price levels simultaneously at different trading centers. They emphasized that a trade-through rule should accommodate this trading strategy by freeing each trading center to execute orders immediately without waiting for other trading centers to update their better priced quotations.<sup>86</sup>

The Commission fully agrees with these commenters that intermarket protection against trade-throughs must be workable and implemented in a way that promotes fair and orderly markets. It therefore has formulated the repropose Trade-Through Rule to achieve this objective in a variety of ways. First and most importantly, only automated trading centers, as defined in Rule 600(b)(4), that are capable of providing immediate responses to incoming orders would be eligible to have their quotations protected. Moreover, an automated trading center is required to identify its quotations as manual (and therefore not protected) whenever it has reason to believe that it is not capable of providing immediate responses to orders. Thus, a trading center that experiences a systems

<sup>78</sup> Instinet Letter at 17.

<sup>84</sup> Hudson River Trading Letter at 3. This commenter also raised a number of quite specific questions concerning the operation of an intermarket trade-through rule. To address these detailed order sequencing and response scenarios, trading centers would be entitled to adopt policies and procedures that reasonably resolve the practical difficulties of handling fast-arriving orders in a fair and orderly fashion. For example, if a trading center routed orders to other markets to access the full size of protected quotations under the repropose Trade-Through Rule, it would be allowed to continue trading without regard to a particular market's quotations until it has received a response from such market. With respect to concern that traders would not be able to control the routing of their own orders if markets are required to route out to other markets, a trader's use of the IOC functionality specified in Rule 600(b)(3) would preclude the first market from routing to other markets.

<sup>85</sup> Nasdaq Letter III at 3-4.

<sup>86</sup> See, e.g., Brut Letter at 10; Citigroup Letter at 10; E\*Trade Letter at 8; Goldman Sachs Letter at 7.

<sup>78</sup> See, e.g., Letter from Joseph M. Velli, Senior Executive Vice President, The Bank of New York, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 ("BNY Letter") at 2; E\*Trade Letter at 6; ICI Letter at 7, 13; Morgan Stanley Letter at 6.

<sup>79</sup> See, e.g., Citigroup Letter at 6; ICI Letter at 13; Morgan Stanley Letter at 7; Nasdaq Letter II at 13-14; Vanguard Letter at 5.

<sup>80</sup> ICI Letter at 13.

<sup>81</sup> See, e.g., Hudson River Trading Letter at 3; Instinet Letter at 18-19; Morgan Stanley Letter at 11-12; Letter from Edward S. Knight, The Nasdaq Stock Market, Inc., to Jonathan G. Katz, Secretary, Commission, dated September 29, 2004 ("Nasdaq Letter III") at 3.

<sup>82</sup> Morgan Stanley Letter at 12.

problem, whether because of a flood of orders or otherwise, must immediately identify its quotations as manual.

If the repropoed Trade-Through Rule were adopted, the Commission would monitor and enforce the foregoing requirements for automated trading centers and automated quotations. Nevertheless, it concurs with commenters' concerns that well-functioning trading centers should not be dependent on the willingness and capacity of other markets to meet, and the Commission's ability to enforce, these automation requirements. The Trade-Through Rule therefore provides a "self-help" remedy that would allow trading centers to bypass the quotations of a trading center that fails to meet the immediate response requirement. Rule 611(b)(1) sets forth an exception that applies to quotations displayed by trading centers that are experiencing a failure, material delay, or malfunction of its systems or equipment. To implement this exception consistent with the requirements of Rule 611(a), trading centers would have to adopt policies and procedures reasonably designed to avoid dealing with problem trading centers. Such policies and procedures would need to set forth specific and objective parameters for initiating and monitoring compliance with the self-help remedy. Given current industry capabilities, the Commission believes that trading centers should be entitled to bypass another trading center's quotations if it repeatedly fails to respond within one second to incoming orders attempting to access its protected quotations. Accordingly, trading centers would have the necessary flexibility to respond to problems at another trading center as they occur during the trading day. The Commission, of course, also would monitor a trading center's compliance with the policies and procedures required by Rule 611(a) to affirm that the trading center bypasses quotations only when, in fact, another trading center is experiencing a material delay.

In many active NMS stocks, the price of a trading center's best displayed quotations often can change multiple times in a single second ("flickering quotations"). These rapid changes can create the impression that a quotation was traded-through, when in fact the trade was effected nearly simultaneously with display of the quotation.<sup>87</sup> To address the problem of

flickering quotations, repropoed Rule 611(b)(8) sets forth an exception that allows trading centers a one-second "window" prior to a transaction for trading centers to evaluate the quotations at another trading center. Trading centers would be entitled to trade at any price equal to or better than the least aggressive best bid or best offer, as applicable, displayed by the other trading center during that one-second window.<sup>88</sup> For example, if the best bid price displayed by another trading center has flickered between \$10.00 and \$10.01 during the one-second window, the trading center that received the order could execute a trade at \$10.00 without violating Rule 611. By addressing the flickering quotation problem in this way, repropoed Rule 611(b)(8) would give trading centers added flexibility to deal with the practical difficulties of protecting quotations displayed by other trading centers.

The Commission believes that excepting flickering prices from trade-through protection would ease the implementation of the repropoed Trade-Through Rule without significantly reducing its benefits.<sup>89</sup> In this regard, it appears that many of the potential implementation difficulties with respect to high-volume stocks are related to the general problem of dealing with sub-second time increments. The Commission generally does not believe that the benefits would justify the costs imposed on trading centers of attempting to implement an intermarket price priority rule at the level of sub-second time increments. Accordingly,

Katz, Secretary, Commission (no date) ("Lava Trading Letter") at 5; SIA Letter at 10; Letter from Mary McDermott-Holland, Chairman & John C. Giesea, President, Security Traders Association, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 ("STA Letter") at 5.

<sup>88</sup> The Commission emphasizes that repropoed Rule 611 is designed to facilitate intermarket trade-through protection only. Compliance with the Rule would not be a substitute for meeting the best execution responsibilities of brokers-dealers. As a result, the best execution responsibilities of broker-dealers that engage in "price-matching" business practices that depend on the NBBO would not be affected by Rule 611's exception for flickering quotations. In making a best execution determination, for example, a broker-dealer could not rely on the Rule's exception to justify ignoring a recently displayed, better-priced quotation when experience shows that the quotation is likely to be accessible.

<sup>89</sup> Even with the one-second exception for flickering quotations, repropoed Rule 611 would address a large number of trade-throughs that currently occur in the equity markets. The substantial trade-through rates discussed in section II.A.1 above were calculated using a 3-second window. Rule 611 would address all of these trade-throughs, assuming no other exception was applicable.

Rule 611 has been formulated to relieve trading centers of this burden.<sup>90</sup>

Paragraphs (b)(5) and (b)(6) of repropoed Rule 611 set forth exceptions for intermarket sweep orders. The exceptions respond to the need of market participants to access multiple price levels simultaneously at different trading centers. An intermarket sweep order is defined in Rule 600(b)(30) as a limit order that meets the following requirements: (1) The limit order is identified as an intermarket sweep order when routed to a trading center, and (2) simultaneously with the routing of the limit order, one or more additional limit orders are routed to execute against all better-priced protected quotations displayed by other trading centers up to their displayed size. These additional orders also must be marked as intermarket sweep orders to inform the receiving trading center that they can be immediately executed without regard to protected quotations in other markets. Paragraph (b)(5) would allow a trading center to execute immediately any order identified as an intermarket sweep order, without regard for better-priced protected quotations displayed at one or more other trading centers. The exception is fully consistent with the principle of protecting the best displayed prices because it is premised on the condition that the trading center or broker-dealer responsible for routing the order will have attempted to access all better-priced protected quotations up to their displayed size.<sup>91</sup> Consequently, there is no reason why the trading center that receives an intermarket sweep order while displaying an inferior-priced quotation should be required to delay an execution of the order.

Paragraph (b)(6) would authorize a trading center itself to route intermarket sweep orders and thereby enable

<sup>90</sup> Several commenters raised questions concerning "clock drift" and time lags between different data sources. See, e.g., Hudson River Trading Letter at 2; Nasdaq Letter III at 4. These implementation issues would most appropriately be addressed in the context of a trading center's reasonable policies and procedures. Clearly, one essential procedure would be for trading centers to implement clock synchronization practices that meet or exceed industry standards. In addition, a trading center's compliance with the Trade-Through Rule would be assessed based on the times that orders and quotations are received, and trades are executed, at that trading center. In contrast, to comply with the locking/crossing provisions of the repropoed Access Rule (Rule 610(d)), a trading center would be required reasonably to avoid displaying a quotation that would lock or cross a quotation at the time it is displayed by a Plan processor in the consolidated quotation stream.

<sup>91</sup> Reserve size, in contrast, is not displayed. Trading centers and broker-dealers therefore would not be required to route orders to access reserve size.

<sup>87</sup> A number of commenters were concerned about flickering quotations and recommended an exemption to address the problem. CHX Letter at 5; E\*Trade Letter at 9; JP Morgan Letter at 3; Letter from Richard A. Korhammer, Chairman & Chief Executive Officer, Lava Trading Inc., to Jonathan G.

immediate execution of a transaction at a price inferior to a protected quotation at another trading center. For example, paragraph (b)(6) could be used by a dealer that wished immediately to execute a block transaction at a price three cents down from the NBBO, as long as the dealer simultaneously routed orders to access all better-priced protected quotations. By facilitating intermarket sweep orders of all kinds, Rule 611 as repropoed would allow a much wider range of beneficial trading strategies than the rule as proposed. In addition, the intermarket sweep exception would help prevent an "indefinite loop" scenario in which waves of orders otherwise might be required to chase the same quotations from trading center to trading center, one price level at a time.<sup>92</sup>

#### 4. Elimination of Proposed Opt-Out Exception

The rule text of the trade-through proposal included a broad exception for persons to opt-out of the best displayed prices if they provided informed consent. The Proposing Release indicated that the exception was particularly intended to allow investors to bypass manual markets, to execute block transactions without moving the market price, and to help discipline markets that provided slow executions or inadequate access to their quotations.<sup>93</sup> The Commission also noted, however, that an opt-out exception would be inconsistent with the principle of price protection and, if used frequently, could undermine investor confidence that their orders will receive the best available price. It therefore requested comment on an automated execution alternative to the opt-out exception, under which all markets would be required to provide an automated response to electronic orders. At the subsequent NMS Hearing, some panelists questioned whether, assuming only truly accessible and automated quotations were protected, there was a valid reason for opting-out of such a quotation.<sup>94</sup> To address this issue, the Commission requested comment in the Supplemental Release on whether the proposed opt-out exception would be necessary if manual

quotations were excluded from trade-through protection.

Many commenters opposed a general opt-out exception.<sup>95</sup> They believed that it would be inconsistent with the principle of price protection and undermine the very benefits the trade-through rule is designed to provide. American Century, for example, asserted that the Commission should focus on the limit order investors who have "opted-in" to the NMS, rather than on those that wish to opt-out.<sup>96</sup> Vanguard noted that an opt-out exception might serve a short-term desire to obtain an immediate execution, but "without recognizing the second order effect of potentially significantly reducing liquidity in the long term."<sup>97</sup> Similarly, the ICI stated that "while our members may be best served on a particular trade by 'opting-out' from executing against the best price placed in another market, we believe that in the long term, *all* investors will benefit by having a market structure where all limit orders are protected and investors are provided with an incentive to place those orders in the markets."<sup>98</sup> All of the foregoing views were conditioned on an assumption that only accessible, automated quotations would be protected by a trade-through rule.

Many other commenters, in contrast, supported the proposed opt-out exception.<sup>99</sup> Aside from concerns that a trade-through rule would be unworkable without an opt-out exception, which were discussed in the preceding section, the primary concerns of these commenters were that, without an opt-out exception, a trade-through rule would (1) dampen competition among markets, particularly with respect to factors other than price; and (2) restrict the freedom of choice for market participants to route marketable orders to trading centers that are most appropriate for their particular trading objectives and to achieve best execution. As discussed next, the Commission has formulated the repropoed Trade-Through Rule to respond to these

concerns, while still preserving the benefits of intermarket price protection.

a. Preserving Competition Among Markets. Many commenters believed that an opt-out exception was necessary to promote competition among trading centers, particularly competition based on factors other than price, such as speed of response. For example, 179 commenters submitted letters stating that, in the absence of an opt-out exception, "Reg. NMS will freeze market development and, over the long term, could hurt investors."<sup>100</sup> Morgan Stanley asserted that allowing market participants to opt-out "would reward markets that provide faster and surer executions, and conversely, would penalize those markets that are materially slower or are displaying smaller quote sizes by ignoring those quotes."<sup>101</sup> Instinet believed that, without an opt-out exception, a trade-through rule "would virtually eliminate intermarket competition by forcing operational and technological uniformity on each marketplace, negating price competition, system performance, or any other differentiating feature that a market may develop."<sup>102</sup>

The Commission recognizes the vital importance of preserving vigorous competition among markets, but believes that commenters have overstated the risk that such competition would be dampened by adoption of a trade-through rule without a general opt-out exception. Even if repropoed Rule 611 were adopted, markets likely would have strong incentives to continue to compete and innovate to attract both marketable orders and limit orders. Market participants and intermediaries responsible for routing marketable orders, consistent with their desire to achieve the best price and their duty of best execution, would continue to rank trading centers according to the total range of services provided by those markets. Such services include cost, speed of response, sweep functionality, and a wide variety of complex order types. The most competitive trading center would be the first choice for routing marketable orders, thereby enhancing the likelihood of execution for limit orders routed to that trading center. Because likelihood of execution is of such great importance to limit orders, routers of limit orders would be attracted to this preferred trading center. More limit orders would enhance the depth and liquidity offered by the

<sup>92</sup> The indefinite loop scenario also is addressed by (1) the self-help remedy in repropoed Rule 611(b)(1) for trading centers to deal with slow response times and (2) the requirement that trading centers immediately stop displaying automated (and therefore protected) quotations when they can no longer meet the immediate response requirement for automated quotations.

<sup>93</sup> Proposing Release, 69 FR at 11138.

<sup>94</sup> Hearing Tr. at 32, 58, 65, 74, 80, 84–85, 154.

<sup>95</sup> See *supra*, note 38 (overview of commenters supporting a strong trade-through rule without an opt-out exception).

<sup>96</sup> American Century Letter at 4.

<sup>97</sup> Vanguard Letter at 5.

<sup>98</sup> ICI Letter at 14 (emphasis in original).

<sup>99</sup> Approximately 367 commenters supported an opt-out exception. Approximately 211 of these commenters opposed a trade-through rule and endorsed an opt-out to remediate what they viewed as its adverse effects. Of these 211 commenters, 179 commenters utilized Form Letter C. The remaining commenters supporting an opt-out exception included a variety of securities industry participants and 15 members of Congress.

<sup>100</sup> Letter Type C.

<sup>101</sup> Morgan Stanley Letter at 11–12.

<sup>102</sup> Instinet Letter at 19.

preferred trading center, thereby increasing its attractiveness for marketable orders, and beginning the cycle all over again.<sup>103</sup>

Conversely, trading centers that offer poor services, such as a slower speed of response, likely would rank near the bottom in order-routing preference of most market participants and intermediaries. Whenever the least-preferred trading center was merely posting the same price as other trading centers, orders would be routed to other trading centers. As a result, limit orders displayed on the least preferred trading center would be least likely to be executed in general. Moreover, such limit orders would be the least likely to be executed when prices move in favor of the limit orders, and the most likely to be executed only when prices are moving against the limit order, adding the cost of “adverse selection” to the cost of a low likelihood of execution. In sum, the lowest ranked trading center in order-routing preference, with or without intermarket price protection, would suffer the consequences of offering a poor range of services to the routers of marketable orders.<sup>104</sup> The Commission therefore preliminarily does not believe that the absence of an opt-out exception would freeze market development or eliminate competition among markets.

b. Promoting the Interests of Both Marketable Orders and Limit Orders. Many commenters that supported an opt-out exception believed that an ability to opt-out of the best displayed prices was necessary to promote full freedom of choice in the routing of marketable orders, and particularly to allow factors other than quoted prices to be considered. For example, 179 commenters submitted a letter stating that “[i]nvestors are driven by price, but prices that are inaccessible either because of lagging execution time within a market or insufficient liquidity at the best price point impact the overall costs associated with trading securities in today’s markets. The Trade Through

rule may harm investors by restricting their ability to achieve best execution, and investors deserve the opportunity to make choices.”<sup>105</sup> Similarly, Fidelity asserted that “as a fiduciary to the mutual funds under our management, we should be free to reach our own informed judgment regarding the market center where our funds’ trades are to be executed, particularly when a delay may open the way for exchange floor members and others to exploit an informational advantage that arises not from their greater investment or trading acumen but merely from their privileged presence on the physical trading floor.”<sup>106</sup>

The Commission agrees that the interests of investors in choosing the trading center to which to route marketable orders are vitally important, but believes that advocates of the opt-out exception have failed to consider the interests of *all* investors—both those who submit marketable orders and those who submit limit orders. A fair and efficient NMS must serve the interests of both types of investors. Moreover, their interests are inextricably linked together. Displayed limit orders are the primary source of public price discovery. They typically set quoted spreads, supply liquidity, and in general establish the public “market” for a stock. The quality of execution for marketable orders, which, in turn, trade with displayed liquidity, depends to a great extent on the quality of market established by limit orders (*i.e.*, the narrowness of quoted spreads and the available liquidity at various price levels).

Limit orders, however, make the first move—when submitted, they must be displayed rather than executed, and therefore offer a “free option” for other market participants to trade a stock by submitting marketable orders and taking the liquidity supplied by limit orders. Consequently, the fate of limit orders is dependent on the choices made by those who route marketable orders. Much of the time, the interests of marketable orders in obtaining the best available price are aligned with those of limit orders that are displaying the best available price. But, as shown by the significant trade-through rates discussed in section II.A.1 above (even for automated quotations in Nasdaq stocks), the interests of marketable orders and limit orders are not always aligned.

One important example where the interests of limit orders and marketable orders often diverge are large, block trades. Several commenters noted that

they often are willing to bypass the best quoted prices if they can obtain an immediate execution of large orders at a fixed price that is several cents away from the best prices.<sup>107</sup> Yet these block trades often will be priced based on the displayed quotations in a stock. They thereby demonstrate the “free-riding” economic externality that, as discussed in section II.A.1 above, is at the heart of the need for intermarket price protection. To achieve the full benefits of intermarket price protection, all investors must be governed by a uniform rule that encompasses their individual trades. For any particular trade, an investor may believe that the best course of action is to bypass displayed quotations in favor of executing larger size immediately. The Commission believes, however, that the long-term strength of the NMS as a whole is best promoted by fostering greater depth and liquidity, and it follows from this that the Commission should examine the extent to which it can encourage the limit orders that provide this depth and liquidity to the market at the best prices. Allowing individual market participants to pick and choose when to respect displayed quotations could undercut the fundamental reason for displaying the liquidity in the first place.

Consequently, the Commission has decided to eliminate the proposed opt-out exception from the reproposal because it could severely detract from the benefits of intermarket order protection. Instead, repropose Rule 611 has been modified to address the concerns of those who otherwise may have felt they needed to opt-out of protected quotations. In particular, it would incorporate an approach that seeks to serve the interests of both marketable orders and limit orders by appropriately balancing these interests in the contexts where they may diverge. In this way, the repropose Trade-Through Rule is intended to promote the overall efficiency of the NMS for all investors.

First and most importantly, repropose Rule 611 would protect only immediately accessible quotations that are available through automatic execution. It would never require investors submitting marketable orders to access “maybe” quotations that, after arrival of the order, are subject to human intervention and thereby create the potential for other market participants to determine whether to honor the quotation. Moreover, as discussed in section II.A.2 above,

<sup>103</sup> Importantly, repropose Rule 611 would not require that limit orders be routed to any particular market, as it does, at least indirectly, marketable orders. Consequently, competitive forces would be fully operative to discipline markets that offer poor services to limit orders, such as limiting the extent to which limit orders can be cancelled in changing market conditions or providing slow speed of cancellation.

<sup>104</sup> As discussed below in section III.A.2, a competitive problem could arise if a least preferred market was allowed to charge exorbitant fees to access its protected quotations, and then pass most of the fee on as rebates to liquidity providers to offset adverse selection costs. To address the problem of such an “outlier” market, repropose Rule 610(c) would set forth a uniform fee limitation for accessing protected quotations.

<sup>105</sup> Letter Type C.

<sup>106</sup> Fidelity Letter I at 6–7.

<sup>107</sup> See, e.g., Fidelity Letter I at 9; Morgan Stanley Letter at 12.



reproposed Rule 611 includes a variety of provisions designed to assure that marketable orders must be routed only to well-functioning trading centers displaying executable quotations.

Second, reproposed Rule 611 has been formulated to promote the interests of investors seeking immediate execution of specific order types that reduce their total trading costs, particularly for larger orders, by, among other things, minimizing price impact costs. Paragraph (b)(7), for example, sets forth an exception that would allow the execution of volume-weighted average price ("VWAP") orders, as well as other types of orders that are not priced with reference to the quoted price of a stock at the time of execution and for which the material terms were not reasonably available at the time the commitment to execute the order was made. This exception would serve the interests of marketable orders and is consistent with the principle of protecting the best displayed quotations.

Although reproposed Rule 611 does not provide a general exception for block orders, it seeks to address the legitimate interest of investors in obtaining an immediate execution in large size (and thereby minimizing price impact). The intermarket sweep order exception would allow broker-dealers to continue to facilitate the execution of block orders. The entire size of a large order can be executed immediately at any price, so long as the broker-dealer routes orders seeking to execute against the full displayed size of better-priced protected quotations. The size of the order therefore need not be parceled out over time in smaller orders that might tip the market about pending orders. By both allowing immediate execution of the large order and protecting better-priced quotations, reproposed Rule 611 is designed to appropriately balance the interests for investors on both sides of the market.

The Commission recognizes, however, that the existence of an intermarket price protection, without an opt-out exception, may interfere to some extent with the extremely short-term trading strategies of some market participants. Some of these strategies can be affected by a delay in order-routing or execution of as little as 3/10ths of one second. Given the current NMS structure with multiple competing markets, any protection of displayed quotations in one market could affect the implementation of short-term trading strategies in another market. This conflict between protecting the best displayed prices and facilitating short-term trading strategies raises a fundamental policy question—should

the overall efficiency of the NMS defer to the needs of professional traders, many of whom rarely intend to hold a position overnight? Or should the NMS serve the needs of longer-term investors, both large and small, that will benefit substantially from intermarket price protection?

The Commission believes that two of the most important public policy functions of the secondary equity markets are to minimize trading costs for long-term investors and to reduce the cost of capital for listed companies. These functions are inherently connected, because the cost of capital of listed companies depends on the trading costs of those who are willing to accept the investment risk of holding corporate stock for an extended period. To the extent that the interests of professional traders and market intermediaries in a broad opt-out exception conflict with those of investors, the interests of investors are entitled to take precedence. In this way, the NMS will fulfill its Exchange Act objectives to promote fair and efficient equity markets for investors and to serve the public interest.

#### 5. Scope of Protected Quotations: Market BBO Alternative and Voluntary Depth Alternative

The trade-through proposal would have protected all quotations disseminated by a Plan processor in the consolidated quote stream. Currently, the scope of these quotations depends on the regulatory status of an SRO. Under Exchange Act Rule 11Ac1-1 ("Quote Rule") (proposed to be redesignated as Rule 602), exchange SROs are required to provide only their best bids and offers ("BBOs") in a stock. In contrast, a national securities association, which currently encompasses Nasdaq's trading facilities and the NASD's ADF, must provide BBOs of its individual members. Consequently, the proposal would have protected only a single BBO of an exchange and not any additional quotations in its depth of book ("DOB"). For Nasdaq facilities and the ADF, however, the proposal would have protected member BBOs at multiple price levels. The Proposing Release requested comment on whether only a single BBO for Nasdaq and the ADF should be protected.<sup>108</sup>

Commenters expressed concern that the proposed rule text would protect the BBOs of individual market makers and ATSS in Nasdaq's facilities and the ADF, but only a single BBO of exchange

SROs.<sup>109</sup> The Specialist Association, for example, believed that it would be unfair to offer greater protection to the quotations of members of an association SRO than to those of an exchange SRO.<sup>110</sup> Morgan Stanley stated that to "equalize the protections available to all market participants, we believe the Commission should treat SuperMontage as a single market for purposes of the trade-through rule, instead of treating each individual Nasdaq market maker as a separate quoting market participant."<sup>111</sup>

The Commission agrees that reproposed Rule 611 should not mandate a regulatory disparity between the quotations displayed through exchange SROs and those displayed through Nasdaq facilities and the ADF. Potentially, Nasdaq and the ADF could attract a significant number of limit orders if they were able to offer order protection that was not available at exchange SROs. This result would not be consistent with the Exchange Act goals of fair competition among markets and the equal regulation of markets.<sup>112</sup> Each of the proposed alternatives for the definition of "protected bid" and "protected offer" in reproposed Rule 600(b)(57) (the Market BBO Alternative and the Voluntary Depth Alternative) therefore encompasses the BBOs of an exchange, Nasdaq, and the ADF. In this way, exchange markets would be treated comparably with Nasdaq and the ADF under either alternative.

The Proposing Release also addressed the issue of extending trade-through protection to DOB quotations, but questioned whether protecting all DOB quotations would be feasible at this time.<sup>113</sup> Comment specifically was requested, however, on whether protection should be extended beyond the BBOs of SROs if individual markets voluntarily provided DOB quotations through the facilities of an effective national market system plan.<sup>114</sup> At the subsequent NMS Hearing, a panelist specifically endorsed the policy and feasibility of extending trade-through protection to DOB quotations, as long as

<sup>109</sup> See, e.g., Goldman Sachs Letter at 6; Morgan Stanley Letter at 8; NYSE Letter, Attachment at 4; Specialist Assoc. Letter at 3.

<sup>110</sup> Specialist Assoc. Letter at 3.

<sup>111</sup> Morgan Stanley Letter at 8.

<sup>112</sup> Exchange Act Section 11A(a)(1)(C)(ii) and 11A(c)(1)(F).

<sup>113</sup> Proposing Release, 69 FR at 11136.

<sup>114</sup> *Id.* The Commission does not believe that markets should be required to disseminate their DOB quotations in the consolidated data stream and thereby obtain trade-through protection for such quotations. Rather, the Voluntary Depth Alternative would allow each market the freedom to choose the course of action most appropriate for its particular competitive strategy.

<sup>108</sup> Proposing Release, 69 FR at 11136.

such quotations were automated and accessible: "Automatically executable quotes, whether they are on the top of the book or up and down the book, should be protected by the trade-through rule, and manual quotes should not be. This is a simple and technically easy idea to implement."<sup>115</sup>

Most of the subset of comment letters that specifically addressed the DOB issue supported the approach of extending trade-through protection to all limit orders displayed in the NMS, not merely the BBOs of the various markets.<sup>116</sup> The Consumer Federation of America, for example, stated that "such an approach would result in better price transparency and help to address complaints that decimal pricing has reduced price transparency because of the relatively thin volume of trading interest displayed in the best bid and offer."<sup>117</sup> The ICI recognized that protecting all displayed limit orders might not be feasible at this time, but urged the Commission to examine the issue further.<sup>118</sup>

The Commission recognizes, however, that other commenters may have chosen not to address the alternative of protecting voluntary DOB quotations because it was not included in the proposed rule text. In this reproposal, therefore, the Commission has decided to propose rule text for two alternatives: (1) The Market BBO Alternative that would protect only the BBOs of the exchange SROs, Nasdaq, and the ADF, or (2) the Voluntary Depth Alternative that, in addition to protecting BBOs, would protect the DOB quotations that markets voluntarily disseminate in the consolidated quotations stream. The alternatives are incorporated in two alternative definitions of "protected bid" and "protected offer" in Rule 600(b)(57). Comment is requested on which of the two alternatives would most further the Exchange Act objectives for the NMS in a practical and workable manner. The following discussion is intended to highlight issues that commenters may wish to address when evaluating the two alternatives.

<sup>115</sup> Hearing Tr. at 57 (testimony of Thomas Peterffy, Chairman, Interactive Brokers Group).

<sup>116</sup> American Century Letter at 2; Ameritrade Letter I at 4; BNY Letter at 2; Capital Research Letter at 2; Consumer Federation Letter at 2; Goldman Sachs Letter at 6; ICI Letter at 8. *See also* ArcaEx Letter at 7 (supports trade-through protection for exchange-listed stocks only, but for entire depth-of-book). *But see* Letter from Samuel F. Lek, Chief Executive Officer, Lek Securities Corporation, to Jonathan G. Katz, Secretary, Commission, dated May 24, 2004 ("Lek Securities Letter") at 7; Specialist Assoc. Letter at 3.

<sup>117</sup> Consumer Federation Letter at 2.

<sup>118</sup> ICI Letter at 8.

Comment is requested on whether extending trade-through protection to DOB quotations would significantly increase the benefits of the repropose Trade-Through Rule. Would protecting quotations at multiple price levels further encourage the display of limit orders and thereby significantly enhance depth and liquidity in the NMS? Since decimalization, quoted spreads have narrowed substantially. Market participants often may not be willing to quote in significant size at the inside prices, but might be willing to do so at a price that is a penny or more away from the inside prices. Granting trade-through protection to such quotations potentially would reward this beneficial quoting activity.

In assessing the potential benefits of DOB protection, commenters should consider the effect of the reserve (or undisplayed) size function that many trading centers offer investors. For example, Market A may be displaying a best offer of 1000 shares at \$10.00, and DOB offers of 2000 shares at \$10.01 and 2000 shares at \$10.02. With a reserve size function, however, Market A may have an additional 1000 shares offered at \$10.00 and an additional 2000 shares offered at \$10.01, neither of which is displayed. Assuming the displayed offers of \$10.00, \$10.01, and \$10.02 were protected quotations under the Voluntary Depth Alternative, Market B could execute a trade at \$10.03 only by simultaneously routing an order to execute against the accumulated displayed size of the protected quotations at Market A. Market B therefore would be required to route a buy order, identified as an intermarket sweep order, to Market A with a limit price of \$10.02 for a total of 5000 shares (the accumulated amount of the displayed size of protected quotations with a price of \$10.02 or better at Market A). Under the priority rules currently in effect at electronic markets, undisplayed size has priority over displayed size at a inferior price. Accordingly, Market A would execute the 5000 share buy order as follows: 2000 shares at \$10.00 (1000 displayed plus 1000 reserve) and 3000 shares at \$10.01 (2000 displayed plus 1000 reserve). While Market B would have complied with the Rule, the displayed \$10.02 offer at Market A would still go unfilled when Market B traded at \$10.03. Comment is requested on the extent to which this outcome would detract from the benefits of the Voluntary Depth Alternative.

The Commission also requests comment on whether the Voluntary Depth Alternative could be implemented in a practical and cost-

effective manner. To comply, trading centers would need to monitor a significantly larger number of protected quotations displayed by other markets and route orders to execute against such quotations.<sup>119</sup> The Voluntary Depth Alternative, however, would not increase the *number* of orders that a trading center would be required to route to other trading centers if only BBOs were protected. Instead, the *size* of the routed orders would need to be increased to reflect the accumulated depth displayed by other trading centers in their protected DOB quotations.

In addition, protection of DOB quotations would not be feasible unless (1) market participants have a source of information that clearly identifies the quotations to be protected, (2) such quotation information is made available on fair and reasonable terms, and (3) market participants have fair and efficient access to the protected quotations at reasonable cost (*i.e.*, without paying exorbitant access fees). Moreover, the applicable regulatory authorities must be able to monitor and enforce compliance with a rule that protected DOB quotations. At a minimum, this would require an objective and uniform source to identify the quotations that are protected at any particular time. Comment is requested on whether the Voluntary Depth Alternative would meet these vitally important requirements.

The Voluntary Depth Alternative would set up a process through which individual markets could choose to secure protection for their DOB quotations by disseminating them in the consolidated quotation stream. To implement this approach, the SRO participants in the market data Plans would need to establish a mechanism for individual markets to disseminate their quotations through the Plan processor and have them designated as protected quotations. The participants in the Nasdaq UTP Plan already have agreed on such a mechanism.<sup>120</sup> It provides that the future processor for the Plan should have the ability to collect, consolidate, and disseminate quotations at multiple price levels beyond the BBO from any participant that voluntarily chooses to submit such quotations. The participant would be expected to bear the costs of processing

<sup>119</sup> As a means to address capacity issues, the SRO participants in the applicable market data Plans potentially could determine to disseminate only those DOB quotations that were within a certain number of price levels away from the NBBO.

<sup>120</sup> Nasdaq UTP Plan, section XXI, Depth of Book Display (published in Securities Exchange Act Release No. 49137 (Jan. 28, 2004), 69 FR 5217, 5225 (Feb. 3, 2004)).

its additional information. If the Voluntary Depth Alternative were adopted and any individual market were willing to disseminate its DOB quotations through the Plan processors, the participants in each of the Plans would be expected to agree on a fair and equitable means to disseminate such quotations.

As noted in section II.A.3 above, any intermarket protection against trade-throughs must be workable and implemented in a way that promotes fair and orderly markets. To the extent commenters are concerned about practical problems with implementing the Trade-Through Rule, would the basis for these concerns be magnified by the Voluntary Depth Proposal? Specifically, comment is requested on all issues relating to the feasibility and desirability of disseminating DOB quotations through Plan processors.<sup>121</sup> For example, would the voluntary dissemination of protected DOB quotations through the Plan processors create a single point of failure that could threaten the stability of trading in NMS stocks?

In addition, it would be inappropriate to extend trade-through protection to any quotation unless it was publicly available and accessible on fair and reasonable terms. For example, the limitation on access fees set forth in repropoed Rule 610(c) would apply to any protected quotation, whether a BBO or DOB quotation. Moreover, any fee charged for DOB information disseminated pursuant to a market data Plan would have to be filed with the Commission for approval. The fee could be approved only if it was fair and reasonable and appropriately justified by Plan participants. The Commission requests comment on how best to evaluate the fairness and reasonableness of fees for DOB quotations if the Voluntary Depth Alternative were adopted.

Finally, the Commission requests comment on the effect that adoption of

<sup>121</sup> In its discussion of the market data proposal, the Proposing Release requested comment on whether and, if so, on what terms Plan processors should be required to disseminate data on behalf of individual markets. Proposing Release, 69 FR at 11184 n. 300. In response, one commenter was concerned that, at a minimum, the Plans should offer all participants the same opportunity on the same terms to disseminate additional data. Instinet Letter at 48. The Commission agrees that the Plans must act fairly and reasonably toward all participants. To assure that the Plans were responsive to individual markets that were willing to display DOB quotations and that they treated such participants fairly and reasonably, the Commission would monitor the deliberations of the Plan operating committees and, if necessary, take action to strengthen the NMS and promote the interests of investors.

the Voluntary Depth Alternative would have on competition among markets. One commenter, for example, suggested that protection of DOB quotations might cause increased fragmentation of liquidity across different markets because limit orders, no matter where displayed, would have price protection.<sup>122</sup> Another commenter, in contrast, asserted that protecting only BBOs would lead to greater fragmentation because limit orders would be routed to any market where they would set or equal the BBO and thereby obtain trade-through protection.<sup>123</sup> Comment is requested on the fragmentation issue, as well as in general on whether protecting DOB quotations would inappropriately limit the terms of market competition so as to harm investors and the efficiency of the NMS. For example, would adoption of the Voluntary Depth Alternative inappropriately reduce the scope of competition among markets to the payment of liquidity rebates for executed limit orders? Comment also is requested on whether adoption of the Voluntary Depth Alternative would generate forces that would lead to a monopolization of trading in a single trading facility.

#### 6. Benefits and Implementation Costs of Trade-Through Rule

Commenters were concerned about the cost of implementing the original trade-through proposal. Some argued that, in general, implementing the proposed rule would be too expensive and would outweigh any perceived benefits of the rule.<sup>124</sup> Commenters also were concerned about the cost of specific requirements in the proposed rule, particularly the procedural requirements associated with the proposed opt-out exception (*e.g.*, obtaining informed consent from customers and disclosing the NBBO to customers).<sup>125</sup>

<sup>122</sup> Letter from Bruce Lisman, Bear, Stearns & Co., Inc., to Jonathan G. Katz, Secretary, Commission, dated November 26, 2004 ("Bear Stearns Letter"), at 2.

<sup>123</sup> Goldman Sachs Letter at 6.

<sup>124</sup> *See, e.g.*, Bloomberg Tradebook Letter at 14; Fidelity Letter I at 12; Instinet Letter at 14, 15; Nasdaq Letter II at 2; Letter from Junius W. Peake, Monfort Distinguished Professor of Finance, Kenneth W. Monfort College of Business, University of Northern Colorado, dated April 23, 2004 ("Peake Letter I") at 2; Reg NMS Study Group Letter at 4; Letter from Richard A. Rosenblatt, Chief Executive Officer, & Joseph C. Gawronski, Chief Operating Officer, Rosenblatt Securities Inc., to William H. Donaldson, Chairman, Commission, dated June 23, 2004 ("Rosenblatt Securities Letter II") at 4; STANY Letter at 3; UBS Letter at 8.

<sup>125</sup> *See, e.g.*, Ameritrade Letter I at 8, 9; Brut Letter at 12; Citigroup Letter at 8-9; E\*TRADE Letter at 7; Letter from W. Leo McBlain, Chairman, & Thomas J. Jordan, Executive Director, Financial

In assessing the implementation costs of the repropoed Trade-Through Rule, it is important to recognize that much, if not all, of the connectivity among trading centers necessary to implement intermarket price protection has already been put in place. Trading centers for exchange-listed securities already are connected through the ITS. The Commission understands that, at least as an interim solution, ITS facilities and rules could be modified relatively easily and at low cost to enable an automatic execution functionality. With respect to Nasdaq stocks, connectivity among trading centers already is established through private linkages. Routing out to other trading centers when necessary to obtain the best prices for Nasdaq stocks is an integral part of the business plan of many trading centers, even when not affirmatively required by best execution responsibilities. Moreover, a variety of private vendors currently offer connectivity to NMS trading centers for both exchange-listed and Nasdaq stocks.

Some of the commenters based their concerns about implementation costs on the estimated costs included in the Proposing Release for purposes of the Paperwork Reduction Act of 1995 ("PRA").<sup>126</sup> The Commission has revised its estimate of the PRA costs associated with the proposed rule to reflect the streamlined requirements of Rule 611 as repropoed, and to reflect a further refinement of the estimated number of trading centers subject to the rule.<sup>127</sup> In particular, Rule 611 as repropoed does not contain the proposed opt-out exception. Costs associated with this proposed exception represented a large portion of the overall estimated costs described in the Proposing Release, and are no longer applicable.<sup>128</sup> In total, eliminating the opt-out procedural requirements alone reduces the estimate of the Proposing Release by \$294 million in start-up costs and \$207 million in annual costs.

The Commission also has refined its estimate of the number of broker-dealers that would be required to establish, maintain, and enforce policies and

Information Forum, to Jonathan G. Katz, Secretary, Commission, dated July 9, 2004 ("Financial Information Forum Letter") at 2; JP Morgan Letter at 4; SIA Letter at 12-14.

<sup>126</sup> 44 U.S.C. 3501 *et seq.*

<sup>127</sup> The revised PRA analysis is forth in section VIII.A below.

<sup>128</sup> Specifically, the estimated costs of providing investors with disclosure necessary to obtain informed consent to opt-outs and retaining records relating to such disclosures were \$100 million in start-up costs and \$59 million annually. Further, the estimated costs of the proposed requirement for broker-dealers to provide every customer that opted out with the NBBO at the time of execution were \$194 million in start-up costs and almost \$148 million annually.

procedures designed to prevent trade-throughs pursuant to the rule as repropoed. In the Proposing Release, the Commission estimated that potentially all of the 6,768 registered broker-dealers would be subject to this requirement, but acknowledged that it believed the figure was likely overly-inclusive because it might include registered broker-dealers that do not effect transactions in NMS stocks.<sup>129</sup> After further consideration, the Commission believes that this number indeed greatly overestimated the number of registered broker-dealers that would be subject to the rule, given that most of those broker-dealers do not engage in the business of executing orders internally. The estimated number therefore has been reduced to approximately 600 broker-dealers.<sup>130</sup>

Taken together, these changes substantially reduce the estimated costs associated with implementation of and ongoing compliance with Rule 611 as repropoed. As discussed further in section VIII.A below, the estimated PRA costs associated with repropoed Rule 611 are \$17.8 million in start-up costs and \$3.5 million in annual costs. In addition, as discussed further in section IX.A.2 below, the estimated implementation costs for necessary systems modifications are \$126 million in start-up costs and \$18.4 million in annual costs. Accordingly, the total estimated costs are \$143.8 million in start-up costs and \$21.9 million in annual costs.

The Commission preliminarily believes that the benefits of strengthening price protection for exchange-listed stocks (e.g., by eliminating the gaps in ITS coverage of block positioners and 100-share quotes) and introducing price protection for Nasdaq stocks would be substantial, although the total amount is difficult to quantify. One objective, though quite conservative, estimate of benefits is the dollar amount of quotations that currently are traded through. The Commission staff's analysis of current trade-through rates indicates that over 12 billion shares of displayed quotations in Nasdaq and NYSE stocks were traded through in 2003, by an average amount of 2.3 cents for Nasdaq stocks and 2.2 cents for NYSE stocks.<sup>131</sup> These traded-through quotations represent approximately \$209 million in Nasdaq stocks and \$112 million in NYSE stocks, for a total of \$321 million in bypassed limit orders and inferior prices for

investors in 2003 that could have been addressed by strong trade-through protection.<sup>132</sup> The Commission preliminarily believes that this \$321 million estimated annual benefit, particularly when combined with the benefits of enhanced investor confidence in the fairness and orderliness of the equity markets, would justify the one-time costs of implementation and ongoing annual costs of the repropoed Trade-Through Rule.

The foregoing estimate of benefits is very conservative because it is based solely on the size of displayed quotations in the *absence* of strong price protection. In essence, it measures the problem—a shortage of quoted depth—that the repropoed Trade-Through Rule is designed to address, rather than the benefits that it could achieve. Every trade-through transaction potentially sends a message to market participants that their displayed quotations can be and are ignored by other market participants. When the total share volume of trade-through transactions that do not interact with displayed quotations reaches 8% and above for hundreds of the most actively traded NMS stocks,<sup>133</sup> this message is unlikely to be missed by those who watched their quotations being traded through. Certainly, the common practice of trading through displayed size is most unlikely to prompt market participants to display even greater size.

A primary objective of the repropoed Trade-Through Rule is to increase displayed depth and liquidity in the NMS and thereby reduce trading costs for a wide spectrum of investors, particularly institutional investors that must trade in large sizes. Precisely estimating the extent to which strengthened price protection would improve market depth and liquidity, and thereby lower the trading costs of investors, is very difficult. The difficulty of estimation should not hide from view, however, the enormous potential benefits for investors of improving the depth and efficiency of the NMS. Because of the huge dollar amount of trading volume in NMS stocks—more than \$17 trillion in 2003<sup>134</sup>—even the most incremental improvement in market depth and liquidity could generate a dollar amount of benefits that annually would dwarf the one-time start-up costs of implementing trade-through protection.

One approach to evaluating the potential benefits of the repropoed Trade-Through Rule is to examine a category of investors that stand to benefit a great deal from improved depth and liquidity for NMS stocks—the shareholders in U.S. equity mutual funds. In 2003, the total assets of such funds were \$3.68 trillion.<sup>135</sup> The average portfolio turnover rate for equity funds was 55%, meaning that their total purchases and sales of securities amounted to approximately \$4.048 trillion.<sup>136</sup> A leading authority on the trading costs of institutional investors has estimated that in the second quarter of 2003 the average price impact experienced by investment managers ranged from 17.4 basis points for giant-capitalization stocks, 21.4 basis points for large-capitalization stocks, and up to 35.4 basis points for micro-capitalization stocks.<sup>137</sup> In addition, it estimated the cost attributable to adverse price movements while searching for liquidity for institutional orders, which often are too large simply to be presented to the market. Its estimate of liquidity search costs ranged from 13 basis points for giant capitalization stocks, 23 basis points for large capitalization stocks, and up to 119 basis points for micro-capitalization stocks. Assuming that the average price impact costs and liquidity search costs incurred across all stocks were a conservative 37.4 basis points,<sup>138</sup> the shareholders in U.S. equity mutual funds incurred implicit trading costs of \$15.1 billion in 2003. Based on a hypothetical assumption that, in light of the current share volume of trade-through transactions that does not interact with displayed liquidity, intermarket trade-through protection could improve depth and liquidity for NMS stocks by at least 5% (or an average reduction of 1.87 basis points in price impact and liquidity search costs for large investors), the savings in trading costs for U.S. equity funds alone,

<sup>135</sup> Investment Company Institute, *Mutual Fund Fact Book* (2004), at 55.

<sup>136</sup> *Id.* at 64. Portfolio turnover is reported as the lesser of portfolio sales or purchases divided by average net assets. Because price impact occurs for both purchases and sales, the turnover rate must be doubled, then multiplied by total fund assets, to estimate the total value of trading that would be affected by an improvement in depth and liquidity.

<sup>137</sup> Plexus Group, Inc., Commentary 80, "Trading Truths: How Mis-Measurement of Trading Costs Is Leading Investors Astray," (April 2004), at 2–3.

<sup>138</sup> The estimate of 37.4 basis points is the average of the total market impact and liquidity search costs for giant capitalization stocks (30.4 basis points) and the total market impact and liquidity search costs for large capitalization stocks (44.4 basis points). The much higher market impact and liquidity search costs of midcap, smallcap, and microcap stocks are not included.

<sup>129</sup> Proposing Release 69 FR at 11145 n.95.

<sup>130</sup> The estimate is described further in section VIII.A below.

<sup>131</sup> Trade-Through Study at 3, 5.

<sup>132</sup> *Id.* at 3.

<sup>133</sup> See Trade-Through Study, Tables 4 and 11.

<sup>134</sup> World Federation of Exchanges, *Annual Report* (2003), at 86.

and the improved returns for their millions of individual shareholders, would have amounted to approximately \$755 million in 2003.

Of course, the benefits of improved depth and liquidity for the equity holdings of other types of investors, including pension funds, insurance companies, and individuals, are not incorporated in the foregoing calculations. In 2003, these other types of investors held 78% of the value of publicly traded U.S. equity outstanding, with equity mutual funds holding the remaining 22%.<sup>139</sup> Assuming that these other types of investors experienced a reduction in trading costs that merely equaled the reduction of trading costs for equity mutual funds, the assumed 5% improvement in market depth and liquidity could yield total trading cost savings for all investors of over \$1.5 billion annually. Such savings would improve the investment returns of equity ownership, thereby promoting the retirement and other long-term financial interests of individual investors and reducing the cost of capital for listed companies.

#### B. Description of Reproposed Rule

Reproposed Rule 611 can be divided into three elements: (1) The provisions that establish the scope of the Rule's coverage, most of which are set forth in the definitions of Rule 600(b); (2) the operative requirements of paragraphs (a) of Rule 611, which, among other things, mandate the adoption and enforcement of written policies and procedures that are reasonably designed to prevent trade throughs of protected quotations and, if relying on an exception, that are reasonably designed to assure compliance with the terms of the exception, and (3) the exceptions set forth in paragraph (b) of Rule 611. These elements are discussed below, followed by a section emphasizing that a broker's duty of best execution would in not be lessened if repropose Rule 611 were adopted.

#### 1. Scope of Rule

The scope of repropose Rule 611 would largely be determined by a series of definitions set forth in Rule 600(b). In general, the Rule would address trade-throughs of protected quotations in NMS stocks by trading centers. A "trading center" is defined in Rule 600(b)(78) as a national securities exchange or national securities association that operates an SRO trading

facility,<sup>140</sup> an ATS,<sup>141</sup> an exchange market maker,<sup>142</sup> an OTC market maker,<sup>143</sup> or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent. This last phrase is intended particularly to cover block positioners. An "NMS stock" is defined in paragraphs (b)(47) and (b)(46) of Rule 600 as a security, other than an option, for which transaction reports are collected, processed and made available pursuant to an effective national market system plan. This definition effectively covers stocks listed on a national securities exchange and stocks included in either the National Market or SmallCap tiers of Nasdaq. It does not include stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market.

The term "trade-through" is defined in Rule 600(b)(77) as the purchase or sale of an NMS stock during regular trading hours,<sup>144</sup> either as principal or agent, at a price that is lower than a protected bid or higher than a protected offer. Rule 600(b)(57), which defines a "protected bid" or "protected offer,"<sup>145</sup> includes three main elements: (1) An automated quotation, (2) displayed by an automated trading center, and (3) alternative proposals for the scope of quotations that are to be protected—the Market BBO Alternative and the Voluntary Depth Alternative. These three elements are described in more detail below.

As discussed above, an "automated quotation" is defined in repropose Rule 600(b)(3) as a quotation displayed by a trading center that: (1) Permits an incoming order to be marked as immediate-or-cancel; (2) immediately and automatically executes an order marked as immediate-or-cancel against the displayed quotation up to its full size; (3) immediately and automatically cancels any unexecuted portion of an order marked as immediate-or-cancel without routing the order elsewhere; (4) immediately and automatically transmits a response to the sender of an

order marked as immediate-or-cancel indicating the action taken with respect to such order; and (5) immediately and automatically displays information that updates the displayed quotation to reflect any change to its material terms.

Consequently, a quotation would not qualify as "automated" if any human intervention after the time an order is received is allowed to determine the action taken with respect to the quotation. The term "immediate" precludes any coding of automated systems or other type of intentional device that would delay the action taken with respect to a quotation. Although a trading center must provide an IOC/no-routing functionality for incoming orders, it also can offer additional functionalities. Among the changes to material terms that require an immediate update to a quotation are price, size, and automated/manual indicator. Any quotation that does not meet the requirements for an automated quotation is defined in Rule 600(b)(37) as a "manual quotation."

As discussed above, an "automated trading center" is defined in repropose Rule 600(b)(4) as a trading center that: (1) Has implemented such systems and rules as are necessary to render it capable of displaying quotations that meet the requirements for an automated quotation set forth in paragraph (b)(3) of this section; (2) identifies all quotations other than automated quotations as manual quotations; (3) immediately identifies its quotations as manual quotations whenever it has reason to believe that it is not capable of displaying automated quotations; and (4) has adopted reasonable standards limiting when its quotations change from automated quotations to manual quotations, and vice versa, to specifically defined circumstances that promote fair and efficient access to its automated quotations and are consistent with the maintenance of fair and orderly markets. The requirement of reasonable standards for switching the automated/manual status of quotations is designed to preclude any practices that would cause confusion among market participants concerning the status of a trading center's quotations or that would inappropriately advantage the members or customers of a trading center at the expense of the public.

The third element of the definition of protected quotations in Rule 600(b)(57) addresses the scope of quotations displayed by a trading center that are entitled to protected status. As discussed above, the Commission is requesting comment on two alternatives. Under the Market BBO Alternative, only an automated quotation that is the BBO

<sup>140</sup> An "SRO trading facility" is defined in repropose Rule 600(b)(72) as a facility operated by an SRO that executes orders in a security or presents orders to members for execution.

<sup>141</sup> An "alternative trading system" is defined in repropose Rule 600(b)(2) with a cross reference to Regulation ATS.

<sup>142</sup> An "exchange market maker" is defined in repropose Rule 600(b)(24).

<sup>143</sup> An "OTC market maker" is defined in repropose Rule 600(b)(52).

<sup>144</sup> The term "regular trading hours" is defined in repropose Rule 600(b)(64) as the time between 9:30 a.m. and 4 p.m., unless otherwise specified.

<sup>145</sup> Protected bid and protected offer are collectively defined as a "protected quotation" in repropose Rule 600(b)(58).

<sup>139</sup> Mutual Fund Factbook, *supra* note 135, at 59.

of an exchange SRO, the BBO of Nasdaq, and the BBO of the NASD (*i.e.*, the ADF) would qualify as a protected quotation. The Voluntary Depth Alternative would protect, in addition to all of the quotations protected under the Market BBO Alternative, such additional bids or offers that are designated as protected bids or protected offers pursuant to an effective national market system plan. Thus, the minimum quotations that would be protected at present under either alternative are the BBOs of each exchange SRO, The NASDAQ Market Center, and the NASD's ADF. In addition, the Voluntary Depth Alternative would establish a mechanism pursuant to which a market, on a *voluntary* basis, would be allowed to obtain trade-through protection for its DOB quotations. In particular, the market would need to arrange to have its DOB quotations designated as protected pursuant to one of the market data Plans. Section II.A.5 above discusses the two alternatives and requests comment on specific issues.

## 2. Requirement of Reasonable Policies and Procedures

Paragraph (a)(1) of re-proposed Rule 611 would require a trading center to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs of protected quotations in NMS stocks that do not fall within an exception set forth in paragraph (b) of Rule 611 and, if relying on such an exception, that are reasonably designed to assure compliance with the terms of the exception. In addition, paragraph (a)(2) of Rule 611 would require a trading center to regularly surveil to ascertain the effectiveness of the policies and procedures required by paragraph (a)(1) and to take prompt action to remedy deficiencies in such policies and procedures. As discussed in the Proposing Release, the Commission continues to believe that it would be inappropriate to implement a complete prohibition against any trade-throughs, particularly given the realities of intermarket trading and order-routing in many high-volume NMS stocks.<sup>146</sup> The requirement of written policies and procedures, as well as the responsibility assigned to trading centers to regularly surveil to ascertain the effectiveness of their procedures and take prompt remedial steps, is intended to achieve the objective of eliminating all trade-throughs that reasonably can be

prevented, while also recognizing the inherent difficulties of eliminating trade-through transactions that, despite a trading center's reasonable efforts, may occur due to random and accidental causes. The Commission requests comment, however, on whether this approach is sufficient to address enforceability concerns. In this regard, should the Commission, instead or in addition, explicitly prohibit trade-throughs absent an applicable exception? Could a prohibition against trade-throughs be fashioned that would establish a fair, effective, and workable standard to govern trading center conduct?

At a minimum, a trading center's policies and procedures must enable the trading center (and persons responsible for transacting on its market, such as specialists) to monitor, on a real-time basis, the protected quotations displayed by other trading centers so as to determine the prices at which the trading center can and cannot execute trades. In addition, a trading center's policies and procedures must establish objective standards and parameters governing its use of the exceptions set forth in Rule 611(b). A trading center's automated order-handling and trading systems must be programmed in accordance with these policies and procedures. Finally, the trading center must take such steps as are necessary to enable it to enforce its policies and procedures effectively. For example, trading centers will need to establish procedures such as regular exception reports to evaluate their trading and order-routing practices. Such reports would need to be examined to affirm that a trading center's policies and procedures have been followed by its personnel and properly coded into its automated systems and, if not, to promptly identify the reasons and take remedial action.

Of course, surveillance is an important component of a trading center's satisfaction of its legal obligations. In the context of this rulemaking, paragraph (a)(2) of Rule 611 would reinforce the ongoing enforcement requirement by explicitly assigning an affirmative responsibility to trading centers to surveil to ascertain the effectiveness of their policies and procedures. Trading centers cannot merely establish policies and procedures that may be reasonable when created and assume that such policies and procedures continue to satisfy the requirements of Rule 611. Rather, trading centers must regularly assess the continuing effectiveness of their procedures and take prompt action when needed to remedy deficiencies.

## 3. Exceptions

Rule 611(b) sets forth a variety of exceptions addressing transactions that may fall within the definition of a trade-through, but which would not be subject to the operative requirements of the Rule. The exceptions primarily are designed to achieve workable intermarket price protection and to facilitate certain trading strategies and order types that are useful to investors, but also are consistent with the principle of price protection.

Paragraph (b)(1) excepts a transaction if the trading center displaying the protected quotation that was traded through was experiencing a failure, material delay, or malfunction of its systems or equipment when the trade-through occurred. As discussed in section II.A.3 above, the exception for a "material delay" would give trading centers a self-help remedy if another trading center repeatedly fails to provide an immediate (within one second under current trading conditions) response to incoming orders attempting to access its quotes. The trading center receiving an order could only be held responsible for its own turnaround time (*i.e.*, from the time it first received an order to the time it transmits a response to the order). Accordingly, the routing trading center would be required to develop policies and procedures that allow for any potential delays in transmission not attributable to the receiving trading center. Trading centers would need to establish reasonable and objective parameters governing their use of the material delay exemption. For example, a single failure to respond within one second generally would not justify future bypassing of another trading center's quotations. Many failures to respond within one second in a short time period, in contrast, clearly would warrant use of the exception. Moreover, prior to disregarding quotations, a trading center should attempt to resolve the problem by contacting the other trading center that has failed to respond immediately.

Paragraph (b)(8) of Rule 611 sets forth an exception for flickering quotations. It excepts a transaction if the trading center displaying the protected quotation that was traded through had displayed, within one second prior to execution of the trade-through, a best bid or best offer, as applicable, for the NMS stock with a price that was equal or inferior to the price of the trade-through transaction. This exception thereby provides a "window" to address false indications of trade-throughs that in actuality are attributable to rapidly

<sup>146</sup> Proposing Release, 69 FR at 11137 (noting the problem of "false positive" trade-throughs caused by rapidly changing quotations, even when a trading center took reasonable precautions to prevent trade-throughs).

moving quotations. It also potentially would reduce the number of instances in which a trading center must alter its normal trading procedures and route orders to other trading centers to comply with repropoed Rule 611. The exception is thereby intended to promote more workable intermarket price protection.

Paragraphs (b)(5) and (b)(6) of Rule 611 set forth exceptions for intermarket sweep orders. An intermarket sweep order is defined in Rule 600(b)(30) as a limit order<sup>147</sup> that meets the following requirements: (1) when routed to a trading center, the limit order is identified as an intermarket sweep order, and (2) simultaneously with the routing of the limit order identified as an intermarket sweep order, one or more additional limit orders, as necessary, are routed to execute against the full displayed size of all protected quotations with a superior price. These additional limit orders must be marked as intermarket sweep orders to allow the receiving market center to execute the order immediately without regard to better-priced quotations displayed at other trading centers (by definition, each of the additional limit orders would meet the requirements for an intermarket sweep order). Paragraph (c) of Rule 611 would require that the trading center or broker-dealer responsible for the routing of an intermarket sweep order take reasonable steps to establish that orders are properly routed in an attempt to execute against all applicable protected quotations. A trading center or broker-dealer would be required to satisfy this requirement regardless whether it routes the order through its own systems or sponsors a customer's access through a third-party vendor's systems. Paragraph (b)(5) would allow a trading center immediately to execute any order identified as an intermarket sweep order. It therefore need not delay its execution for the updating of the better-priced quotations at other trading centers to which orders were routed simultaneously with the intermarket sweep order. Paragraph (b)(6) would allow a trading center itself to route intermarket sweep orders and thereby clear the way for immediate internal executions at the trading center. This

<sup>147</sup> Such a limit order would be "marketable" because it would be immediately subject to execution at current displayed prices. Consequently, "limit order" is used differently in this context than elsewhere in this release, where it is used to refer to non-marketable orders that generally will be displayed, in contrast to marketable orders that generally will not be displayed. See *supra*, note 34 (description of marketable limit orders and non-marketable limit orders).

exception particularly would facilitate the immediate execution of block orders by dealers on behalf of their institutional clients.

To illustrate the operation of the intermarket sweep order exception, assume that the Market BBO Alternative were adopted and a broker-dealer's customer wished to sell a large amount of an NMS stock. Trading Center A is displaying the national best bid of 500 shares at \$10.00, along with quotations in its proprietary depth-of-book data feed of 1500 shares at \$9.99, and 5000 shares at \$9.97. The customer decides to sweep all liquidity on Trading Center A down to \$9.97. Assume also that Trading Center B is displaying a protected bid of 2000 shares at \$9.99, Trading Center C is displaying a protected bid of 400 shares at \$9.98, and Trading Center D is displaying a protected bid of 200 shares at \$9.97. The broker-dealer could execute this trade for its customer, subject to its best execution responsibilities, by simultaneously routing the following orders: (1) An intermarket sweep order to Trading Center A with a limit price of \$9.97 and a size of 7000 shares; (2) an intermarket sweep order to Trading Center B with a limit price of \$9.99 and a size of 2000 shares; and (3) an intermarket sweep order to Trading Center C with a limit price of \$9.98 and a size of 400 shares. All of these orders would meet the requirements of Rule 600(b)(30) because the necessary orders simultaneously were routed to execute against the displayed size of all better-priced protected quotations. Trading Centers A, B, and C all could execute their orders immediately without regard to the protected quotations displayed at other trading centers. No order would need to be routed to Trading Center D because the price of its bid was not superior to the most inferior limit price of the order routed to Trading Center A. Assuming the customer obtained a fill for each of its orders at the displayed prices and sizes,<sup>148</sup> it would have been able to obtain an immediate execution of a 9400-share trade by sweeping

<sup>148</sup> An intermarket sweep order could go unfilled because the protected quotation at a trading center was accessed or withdrawn prior to the trading center's receipt of the intermarket sweep order. In addition, the existence of undisplayed orders or reserve size at some trading centers could result in an execution at better prices than may have been indicated by the displayed prices and sizes. The router of an intermarket sweep order would only be responsible, however, for routing orders in accordance with the displayed price and size of protected quotations. Whether the orders actually execute against the protected quotations, or go unfilled because the quotations have been previously executed or withdrawn, is not within the responsibility or control of the router of the intermarket sweep order.

through four price levels at Trading Center A, while also honoring the protected quotations at two other trading centers. The trade therefore would have both upheld the principle of price protection and served the customer's legitimate interest in obtaining an immediate execution of large size.

The exception in paragraph (b)(7) of Rule 611 would facilitate other types of orders that often are useful to investors—benchmark orders. It would except the execution of an order at a price that was not based, directly or indirectly, on the quoted price of an NMS stock at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made. A common example of a benchmark order is a VWAP order. Assume a broker-dealer's customer decides to buy a stock at 9 a.m. before the markets open for normal trading. The customer submits, and the broker-dealer accepts, an order to buy 100,000 shares at the volume-weighted average price of the stock from opening until 1 p.m. At 1 p.m., the national best offer in the stock is \$20.00, but the relevant volume-weighted average price (in a rising market) is \$19.90. The broker-dealer would be able to rely on the benchmark order exception to execute the order at \$19.90 at 1 p.m., without regard to better-priced protected quotations at other trading centers. Of course, any transactions effected by the broker-dealer during the course of the day to obtain sufficient stock to fill the benchmark order would remain subject to Rule 611. The benchmark exception also would encompass the execution of an order that is benchmarked to a market's single-priced opening, as the Commission would not interpret such an opening price to be the "quoted price" of the NMS stock at the time of execution.<sup>149</sup>

Finally, paragraph (b) of Rule 611 includes a variety of other exceptions: (1) transactions other than "regular way" contracts;<sup>150</sup> (2) single-price

<sup>149</sup> The Commission preliminarily does not believe that "stopped" orders should be excepted from repropoed Rule 611 because their execution is based, at least indirectly, on the quoted price of a stock at the time of execution and their material terms are known when the commitment to execute the order was made. Comment is requested on the extent to which the proposed rule language appropriately designates those transactions that should be excepted because they are consistent with the price protection objectives of repropoed Rule 611.

<sup>150</sup> "Regular way" refers to bids, offers, and transactions that embody the standard terms and conditions of a market. Thus, this exception would apply to a transaction that was executed other than pursuant to standardized terms and conditions, for

opening, reopening, or closing transactions; and (3) transactions executed at a time when protected quotations were crossed. The crossed quotation exception would not apply when a protected quotation crosses a non-protected (e.g., manual) quotation.<sup>151</sup>

#### 4. Duty of Best Execution

The Commission emphasizes that adoption of repropoed Rule 611 would in no way lessen a broker-dealer's duty of best execution. Broker-dealers still must seek the most advantageous terms reasonably available under the circumstances for their customer orders. They must carry out a regular and rigorous review of the quality of markets to evaluate their order execution policies, including their decisions concerning the markets to which to route customer order flow.<sup>152</sup> The protection against trade-throughs that would be provided by Rule 611 would not diminish the broker-dealer's responsibility for evaluating the execution quality of markets, regardless of the exceptions set forth in the Rule. Moreover, Rule 611 could not be used to justify the internal execution of retail orders by a market maker at prices inferior to the best available quotations.

Several commenters who supported excluding manual quotations from trade-through protection also suggested that manual quotations should be excluded from the NBBO that is calculated and disseminated by Plan processors.<sup>153</sup> Under this approach, market participants could disregard manual quotations for purposes of assessing the best execution of customer orders and calculating execution quality statistics under Rule 11Ac1-5 (proposed to be redesignated as Rule 605). The Commission has decided not to propose the elimination of manual quotations

instance a transaction that has extended settlement terms.

<sup>151</sup> Rule 611 as repropoed does not include two exceptions that were included in the proposed rule. One was for trade-throughs of "non-firm" quotations. This exception is unnecessary because a quotation that is not firm would not qualify as an automated, and therefore protected, quotation. The other proposed exception was for a transaction by a trading center experiencing systems problems. To the extent such a transaction is isolated and could not have been reasonably avoided, it would not be addressed by reasonable policies and procedures. If such transactions occurred repeatedly, however, they would call into question whether the trading center in fact had implemented reasonable policies and procedures to prevent trade-throughs.

<sup>152</sup> See generally Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290, 48322-48333 (Sept. 12, 1996) (discussion of best execution responsibilities).

<sup>153</sup> See, e.g., Citigroup Letter at 3, 6; Goldman Sachs Letter at 5-6; Morgan Stanley Letter at 7; SIA Letter at 7.

from the NBBO at this time. Under the Quote Rule, broker-dealers must honor their firm quotations, although the speed of their response may vary according to whether such a quotation is automated or manual. A common business practice of many market makers is to use the NBBO to price investor orders, particularly those of retail investors. Currently, manual quotations establish the NBBO in many NMS stocks. The Commission is concerned that eliminating manual quotations from the NBBO potentially would widen the spreads in many stocks, even though the quotations often may in fact represent the best indication of the current market price of the stock. Of course, broker-dealers would continue to be able to assess the availability of manual quotations in making their best execution analyses.

#### III. Access Rule

For the NMS to fulfill its statutory objectives, fair and efficient access to each of the individual markets that participate in the NMS is essential. One of the NMS objectives, for example, is to assure the practicability of brokers executing investors' orders in the best market.<sup>154</sup> Another is to assure the efficient execution of securities transactions.<sup>155</sup> Clearly, neither of these objectives can be achieved if brokers cannot fairly and efficiently route orders to execute against the best quotations for a stock, wherever such quotations are displayed in the NMS. In 1975, Congress determined that the "linking of all markets" for NMS stocks through communications and data processing facilities would "foster efficiency; enhance competition; increase the information available to brokers, dealers, and investors; facilitate the offsetting of investors' orders; and contribute to the best execution of investors' orders."<sup>156</sup> Since 1975, there have been dramatic improvements in communications and processing technologies. Repropoed Rule 610 is intended to capitalize on these improvements and thereby enhance the "linking of all markets" for the future NMS.

All SROs that trade exchange-listed stocks currently are linked through ITS, a collective intermarket linkage facility. ITS provides a means of access to exchanges and Nasdaq by permitting each market to send a "commitment to trade" through the system, with receiving markets generally having up to

30 seconds to respond.<sup>157</sup> ITS also provides access to quotations of participants without fees and establishes uniform rules to govern quoting practices.<sup>158</sup> Thus, while ITS promotes access that is uniform and free, it also is often slow and limited. Moreover, it is governed by a unanimous vote requirement that impedes innovation.

In contrast, there is no collective intermarket linkage system for SROs that trade Nasdaq stocks. Instead, access is achieved primarily by private linkages among individual trading centers. This approach has demonstrated its advantages among electronic markets. It is flexible and can readily incorporate technological advances as they occur. There is no intermarket system, however, that offers free access to quotations in Nasdaq stocks. Nor are the trading centers for Nasdaq stocks subject to uniform intermarket standards governing their quoting and trading practices. The fees for access to quotations in Nasdaq stocks, as well as the absence of standards for quotations that lock and cross markets, have been the source of severe disputes among participants in the market for Nasdaq stocks for many years. Moreover, private linkages have not worked effectively with respect to the Amex manual trading of Nasdaq stocks, nor have they been successful in preventing intentional barriers to access, especially involving fees.

Repropoed Rule 610 is based on the Commission's determination that fair and efficient access to markets could be achieved without a collective intermarket linkage facility such as ITS.<sup>159</sup> It repropoed a private linkage approach for all NMS stocks, but with modifications to address the most serious problems that have arisen with this approach in the trading of Nasdaq stocks. Rule 610 would address three subject areas: (1) access to quotations, (2) fees for access to protected quotations, and (3) locking and crossing quotations. In addition, the Commission is repropoed a modification to the fair access requirements of Regulation ATS that would extend their application to ATSs with 5% of trading volume in a security.<sup>160</sup>

<sup>157</sup> ITS Plan, Section 6(b)(i).

<sup>158</sup> ITS Plan, Sections 6(b), 8(d), and 11(b).

<sup>159</sup> Were repropoed Rule 610 to be adopted, the Commission anticipates that SRO participants would be permitted to withdraw from the ITS Plan, assuming they had otherwise arranged to meet their access responsibilities.

<sup>160</sup> The modification of Regulation ATS is discussed in section III.B.4 below.

<sup>154</sup> Section 11A(a)(1)(C)(iv) of the Exchange Act.

<sup>155</sup> Section 11A(a)(1)(C)(i) of the Exchange Act.

<sup>156</sup> Section 11A(a)(1)(D) of the Exchange Act.



### A. Response to Comments and Basis for Reproposed Rule

#### 1. Access to Quotations

Paragraphs (a) and (b) of repropose Rule 610 would address access to quotations. Among the variety of services offered by equity markets, access to displayed quotations, particularly the best quotations of a trading center, is most vital for the smooth functioning of intermarket trading. Brokers responsible for routing their customers' orders, as well as investors that make their own order-routing decisions, clearly must have fair and efficient access to the best quotations of all trading centers to achieve best execution of those orders. In addition, trading centers themselves must have the ability to execute orders against the displayed quotations of other market centers. Indeed, the very existence of intermarket protection against trade-throughs is premised on the ability of trading centers to trade with, rather than trade through, the protected quotations displayed by other trading centers.

Access to quotations, sometimes referred to as "order execution access,"<sup>161</sup> should be distinguished from a broader type of access that encompasses all of the different types of services offered by markets, such as the right to display limit orders or to submit complex order types. To obtain the full range of their services, markets generally require that an individual or firm become members or subscribers of the market. This type of access, or "membership access," subsumes access to quotations and is governed by particular regulatory requirements. Sections 6(b)(2) and 15A(b)(3) of the Exchange Act, for example, provide for fair access to membership in SROs. Similarly, Rule 301(b)(5) of Regulation ATS prohibits certain high volume ATSs from denying fair access to their services.<sup>162</sup> Reproposed Rule 610(a) and (b), in contrast, would only address the responsibilities of trading centers to provide order execution access to their quotations.

The access proposal sought to achieve the goal of fair and efficient access to quotations primarily by prohibiting trading centers from unfairly discriminating against non-members or non-subscribers that attempt to access quotations through a member or

subscriber of the trading center. Market participants could either become members or subscribers of a trading center to obtain direct access to its quotations, or they could obtain indirect access by "piggybacking" on the direct access of members or subscribers. These forms of access are widely used today in the market for Nasdaq stocks (as well as to a lesser extent in the market for exchange-listed stocks). Instead of every market participant establishing separate linkages with every trading facility, many different private firms have entered the business of linking with a wide range of trading centers and then offering their customers access to those trading centers through the private firms' linkages. Competitive forces determine the types and costs of these private linkages.

Most commenters supported this private linkage approach for access to quotations.<sup>163</sup> They frequently noted the success of private linkages among electronic markets for Nasdaq stocks and contrasted the speed and usefulness of those linkages with the ITS linkage for exchange-listed stocks. Morgan Stanley noted that "[p]rivate linkages are much easier to establish and operate and can be constructed directly between [order execution facilities] or through market intermediaries. The smooth operation of the market for Nasdaq stocks today clearly demonstrates the power of private linkages."<sup>164</sup> The SIA stated 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."<sup>165</sup> The NYSE concluded that "[i]n the market for listed stocks, we believe that proposed Regulation NMS will provide the framework for alternatives to ITS for intermarket access."<sup>166</sup>

A few commenters opposed the proposed private linkages approach.<sup>167</sup> Some questioned whether multiple

private linkages could match the efficiency of a single, uniform intermarket linkage, although they generally emphasized that the current ITS linkage needed to be enhanced. The BSE, for example, stated that "[m]ultiple individual links to every market is not an economical or practical solution and it would enable gaming opportunities within the markets via technology."<sup>168</sup> The Alliance of Floor Brokers suggested that problems with the ITS linkage, such as its slow speed and lack of structural flexibility, "should be addressed before it is determined to replace it with some, as yet unspecified, routing methodology or mechanism."<sup>169</sup> The Commission has considered these views, but preliminarily believes that the benefits of private linkages, including their flexibility to meet the needs of different market participants and the scope they allow for competitive forces to determine linkages, justifies reliance on this model rather than a single intermarket linkage.

Several commenters, including some that otherwise supported the proposal, expressed concern about particular problems that might arise under a private linkage approach.<sup>170</sup> Some were concerned that requiring non-discriminatory access to markets might undermine the value of SRO membership. CHX stated that "[b]y requiring the Exchange to grant non-members access to the full capabilities of its order execution systems, the Commission's fair access proposal would inappropriately require the Exchange's members to help fund the costs of operating a market that could be routinely used by non-members. It would severely undercut the value of membership and enable non-members to free-ride on the fees paid by members."<sup>171</sup> Amex stated that "to the extent that the proposed rule undermines our right to differentiate between members (who pay fees and have duties and responsibilities to the Exchange) and non-members in our charges, it could effectively remove any incentive for Amex membership."<sup>172</sup>

The Commission does not believe that adoption of a private linkage approach would seriously undermine the value of membership in SROs that offer valuable

<sup>161</sup> See Rule 301(b)(3) of Regulation ATS (order display and execution access requirements).

<sup>162</sup> As discussed in section III.B.4 below, the Commission is repropose an amendment to the fair access requirements of Regulation ATS that would extend their application to ATSs with 5% of trading volume in a security.

<sup>163</sup> See, e.g., Citigroup Letter at 12; Consumer Federation Letter at 4; Goldman Sachs Letter at 4; ICI Letter at 16-17; Morgan Stanley Letter at 17; Nasdaq Letter II at 20; NYSE Letter, Attachment at 6; Letter from Carrie E. Dwyer, General Counsel & Executive Vice President, Charles Schwab & Co., Inc., to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 ("Schwab Letter") at 17; SIA Letter at 16; UBS Letter at 8.

<sup>164</sup> Morgan Stanley Letter at 17.

<sup>165</sup> SIA Letter at 16.

<sup>166</sup> NYSE Letter, Attachment at 7.

<sup>167</sup> See, e.g., Letter from Brendan R. Dowd, Daniel W. Tandy & Ronald Zdrojeski, Alliance of Floor Brokers, to Jonathan G. Katz, Secretary, Commission, dated June 24, 2004 ("Alliance of Floor Brokers Letter") at 2; Ameritrade Letter I, Appendix at 11; BSE Letter at 7; CHX Letter at 13; E\*Trade Letter at 9.

<sup>168</sup> BSE Letter at 7.

<sup>169</sup> Alliance of Floor Brokers Letter at 2.

<sup>170</sup> Alliance of Floor Brokers Letter at 10; Amex Letter, Exhibit A at 25-26; BSE Letter at 12; CHX Letter at 14; Citigroup Letter at 12; Letter from Edith H. Hallahan, First Vice President, Deputy General Counsel, Philadelphia Stock Exchange, to Jonathan G. Katz, Secretary, Commission, dated August 10, 2004 ("Phlx Letter") at 2; STANY Letter at 9.

<sup>171</sup> CHX Letter at 14.

<sup>172</sup> Amex Letter, Exhibit A at 26.

services to their members. First, the fact that markets would not be allowed to impose unfairly discriminatory terms on non-members who obtain indirect access to quotations through members does not mean that non-members would obtain *free* access to quotations. Members who provide piggyback access would be providing a useful service and presumably would charge a fee for such service. The fee would be subject to competitive forces and likely would reflect the costs of SRO membership, plus some element of profit to the SRO's members. As a result, non-members that frequently make use of indirect access are likely to contribute indirectly to the costs of the SRO market. Moreover, the unfair discrimination standard of Rule 610(a) would apply only to access to quotations, not to the full panoply of services that markets generally provide only to their members.

On the other hand, any attempt by an SRO to charge differential fees based on the non-member status of the person obtaining indirect access to quotations, such as whether it is a competing market maker, would violate the anti-discrimination standard of re-proposed Rule 610. As noted above, fair and efficient access to quotes is essential to the functioning of the NMS. To comply with the Trade-Through Rule and their duty of best execution, trading centers often may be required to access the quotations of other trading centers. If a trading center charged discriminatory fees to competitors accessing its quotations, it would interfere in the functioning of the private linkage approach and detract from its usefulness to trading centers in meeting their regulatory responsibilities.

Other types of differential fees, however, would not violate the anti-discrimination standard of re-proposed Rule 610. Fees with volume-based discounts or fees that are reasonably based on the cost of providing a particular service would be permitted, so long as they do not vary based on the non-member status of a person obtaining indirect access to quotations. For example, a member providing indirect access would be entitled to obtain a volume discount on the full amount of its volume, including the volume accounted for by persons obtaining indirect access to quotations.

Another specific concern expressed by commenters about the private linkage approach was assuring efficient linkage to trading centers with a small amount of trading volume that do not make their quotations accessible through an SRO

trading facility.<sup>173</sup> Such quotations currently are displayed only through the ADF, a display-only quotation facility operated by the NASD, and must be accessed directly at the trading center. The proposal would have only required such trading centers to provide access to SROs and other ADF participants. At the NMS Hearing, several panelists expressed concern that this requirement would be inadequate to assure sufficient access, which prompted the Commission to request comment on the matter in its Supplemental Release.<sup>174</sup> It noted that panelists at the NMS Hearing had suggested that relatively inactive ATSs and market makers should be required to publish their quotations in an SRO trading facility, at least until their share of trading reached a point where the cost of direct connections to those markets would not be out of proportion to their volume of trading. Alternatively, the Supplemental Release requested comment on whether an SRO without a trading facility, of which the NASD is currently the only one, should be required to ensure that any ATS or market maker is directly connected to most market participants before publishing its quotations in a display-only facility.

Several commenters supported the approach of requiring low-volume trading centers to make their quotations available through an SRO trading center.<sup>175</sup> Brut, for example, stated that the presence of such low-volume trading centers "requires vast industry investments to establish private connectivity (or utilize vendors) to access these markets—no matter how small or potentially how fleeting—to satisfy best execution obligations and avoid market disruption. The effort and investment to establish such connectivity is disproportionate to the liquidity on such market."<sup>176</sup> Brut further noted that it had sought to avoid such ADF trading centers in the past, but that the extension of trade-through protection to Nasdaq stocks would eliminate this option.

The SIA also believed that "reliance solely on the SEC's proposed market access rules would fail to address access issues related to smaller markets \* \* \*. If the SEC obligates market participants to trade with [a smaller ADF market

maker or ATS] 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."<sup>177</sup> SIA members were divided, however, on the best means to resolve the issue. Some favored requiring smaller trading centers to make their quotes accessible through an SRO trading center. Other SIA members, as well as other commenters, recommended requiring all trading centers to make their best quotations available through a public intermarket linkage facility.<sup>178</sup>

One commenter, in contrast, believed that access to trading centers quoting on the ADF should be addressed by requiring the NASD to add an order execution functionality to ADF. NexTrade stated that the ADF was created to make participation in Nasdaq's SuperMontage facility voluntary. It believed that "the Commission should re-evaluate whether or not 'private sector' solutions for SROs without an execution mechanism are sufficient for the investment community to satisfy its various obligations under the Act."<sup>179</sup>

After considering the various views of commenters, the Commission preliminarily has determined not to require small market centers to make their quotations accessible through an SRO trading facility. As discussed below, it believes that broker-dealers should continue to have the option of trading in the OTC market. Nor is the NASD statutorily required to provide an order execution functionality in the ADF. Instead, the Commission has re-proposed Rule 610(b)(1), which requires all trading centers that choose to display quotations in an SRO display-only quotation facility to provide a level and cost of access to such quotations that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities.

The NASD, as a national securities association, is subject to different regulatory requirements than a national securities exchange. It is responsible for regulating the OTC market (*i.e.*, trading by broker-dealers otherwise than on a national securities exchange). Section 15A(b)(11) of the Exchange Act requires an association to have rules governing the form and content of quotations relating to securities sold otherwise than

<sup>173</sup> Amex Letter at 8; Brut Letter at 19; Citigroup Letter at 13; E\*Trade Letter at 9; Nasdaq Letter II at 22; SIA Letter at 16; Specialist Assoc. Letter at 12; STA Letter at 4; STANY Letter at 10; UBS Letter at 9.

<sup>174</sup> Hearing Tr. at 135, 138–140; Supplemental Release, 69 FR at 30146.

<sup>175</sup> See, e.g., Brut Letter at 13; Citigroup Letter at 13; SIA Letter at 17 (some firms).

<sup>176</sup> Brut Letter at 13.

<sup>177</sup> SIA Letter at 16.

<sup>178</sup> See, e.g., Ameritrade Letter I, Appendix at 11; E\*Trade Letter at 9; SIA Letter at 17.

<sup>179</sup> Letter from John M. Schaible, President, NexTrade Holdings, Inc., to Jonathan G. Katz, Secretary, Commission, dated July 29, 2004 ("NexTrade Letter") at 14.

on a national securities exchange that are published by a member of the association. Such rules must be designed to produce fair and informative quotations and to promote orderly procedures for collecting, distributing, and publishing quotations. The Exchange Act does not, however, require an association to establish a facility for executing orders against the quotations of its members.

ATSs and market makers that wish to trade NMS stocks can choose from a number of options for quoting and trading. They can become a member of a national securities exchange and quote and trade through the exchange's trading facilities. They can participate in the NASDAQ Market Center and quote and trade through that facility. Finally, they can quote and trade in the OTC market. The existence of the NASD's ADF makes this third choice possible by providing a facility for displaying quotations and reporting transactions in the consolidated data stream.<sup>180</sup>

The Commission preliminarily believes that those ATSs and market makers that choose to display quotations in the ADF should bear the responsibility of providing a level and cost of access to their quotations that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities. Although the Exchange Act allows an individual broker-dealer to have the option of trading in the OTC market, it does not mandate that the securities industry in general subsidize the costs of accessing a broker-dealer's quotations in the OTC market. Under repropoed Rule 610(b)(1), therefore, ADF participants would be required to establish the necessary connectivity that would facilitate efficient access to their quotations. As noted in the Commission's order approving the pilot program for the ADF, the reduction in communications line costs in recent years and the advent of competing access providers offer the potential for multiple competitive means of access to the various trading centers that trade NMS stocks.<sup>181</sup> To meet their regulatory requirements, ADF participants would have the option of establishing connections to these industry access providers, which in turn have extensive connections to a wide array of market participants. As the self-regulatory

<sup>180</sup> Under Rule 301(b)(3) of Regulation ATS, an ATS is required to display its quotations in the consolidated data stream only in those securities for which its trading volume reaches 5% of total trading volume.

<sup>181</sup> Securities Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49821 (July 31, 2002).

authority responsible for the OTC market, the NASD would need to assess the extent to which ADF participants have met the access standards of repropoed Rule 610.

## 2. Limitation on Access Fees

Many trading centers charge fees that are triggered when incoming orders execute against their displayed quotations.<sup>182</sup> Such access fees particularly have characterized the business models of ECNs, which typically pass a substantial portion of the access fee on to customers as rebates for supplying the accessed liquidity (*i.e.*, by submitting non-marketable limit orders). For Nasdaq stocks, ECNs have charged access fees directly to their subscribers, but also have charged access fees to non-subscribers when their quotations have been displayed and executed through Nasdaq facilities. Other types of trading centers, including exchange SROs, also charge fees that are triggered when incoming orders access their displayed quotations. These fees have only been charged to their members, because only members have the right to route orders to an exchange other than through ITS. For exchange-listed stocks, moreover, the ITS has provided free intermarket access to quotations for its participants. Finally, market makers have not been permitted to charge any fee for counterparties accessing their quotations under the Quote Rule.

The repropoed trade-through protection and linkage requirements would significantly alter the regulatory landscape that has shaped access fee practices in the past. For exchange-listed stocks, Rule 610 repropoed a private linkage approach that relies on access through members and subscribers rather than through a public intermarket linkage system. For access outside of ITS, markets would pay, directly or indirectly, the fees charged by other markets to their members and subscribers. For Nasdaq stocks, the repropoed Trade-Through Rule would, for the first time, establish price protection, so market participants would no longer have the option of bypassing the quotations of trading centers with access fees that they view as too high.

The benefits of strengthened price protection and more efficient linkages could be compromised if trading centers were able to charge substantial fees for accessing their quotations. Moreover, the wider the disparity in the level of

access fees, the less useful and accurate are the prices of quotations displayed for NMS stocks. For example, if two trading centers displayed offers to buy an NMS stock for \$10.00 per share, one offer might be accessible for a total price of \$10.00 plus a \$0.003 fee and the other offer might be accessible for a total price of \$10.00 plus a \$0.009 fee. If each trading center rebated all except \$0.001 of their fees to liquidity providers (as is often the case), one customer submitting a limit order to sell at \$10.00 would receive \$10.002, while another customer submitting a limit order to sell at \$10.00 would receive \$10.008. What appeared in the consolidated data stream to be identical quotations would in fact be far from identical, and market participants potentially would have powerful incentives to display their limit orders in high fee markets to obtain an economic reward beyond the quoted price of their limit order.

To address the potential distortions caused by substantial, disparate fees, the access proposal included a limitation on fees. Trading centers would have been limited to a fee of no more than \$0.001 per share. Liquidity providers also would have been limited to a fee of no more than \$0.001 per share for attributable quotations, but could not have charged any fee for non-attributable quotations. In addition, the proposal established an accumulated fee limitation of no more than \$0.002 per share for any transaction. At the NMS Hearing, panelists displayed a sharp divergence of opinion on access fees, with some panelists arguing that agency markets must be allowed to charge for services, and other panelists arguing that access fees distort quotation prices.<sup>183</sup> In the Supplemental Release, therefore, the Commission requested comment on all aspects of the proposed fee limitations, including whether it should adopt a single accumulated fee limitation that would apply to all types of market centers, and, if so, whether the proposed \$0.002 per share was an appropriate amount, or whether the amount should be higher or lower.<sup>184</sup>

Commenters were splintered on the issue of access fees. A number were supportive of the Commission's proposal as a worthwhile compromise on an extremely difficult issue.<sup>185</sup> They believed that the proposal would level

<sup>183</sup> See, *e.g.*, Hearing Tr. at 166, 168.

<sup>184</sup> Supplemental Release, 69 FR at 30147.

<sup>185</sup> See, *e.g.*, BNY Letter at 4; Letter from Kenneth Griffin, President & Chief Executive Officer, Citadel Investment Group, L.L.C., to Jonathan G. Katz, Secretary, Commission, dated July 9, 2004 ("Citadel Letter") at 9; Citigroup Letter at 14; E\*Trade Letter at 10; Nasdaq Letter II at 3; SIA Letter (some members) at 18.

<sup>182</sup> A full description of the current framework for access fees is provided in the Proposing Release. 69 FR at 11156.

the playing field in terms of who could charge fees, and provide some measure of certainty to market participants that the quoted price will be, essentially, the price they will pay. Other commenters were strongly opposed to any limitation on fees, believing that competition alone would sufficiently address the high fees that distort quoted prices.<sup>186</sup> One asserted that “[c]ompetitive forces have satisfactorily dealt with the issue of outlier ECNs. . . . [M]arket participants have put them at the bottom of their order routing tables, which means that orders placed on these ECNs would be the last to be executed at any price level, a position that no market participant wants to be in.”<sup>187</sup> In contrast, some commenters argued that all access fees charged to non-members and non-subscribers should be prohibited, but believed that the proposed fee limitations should not apply to SRO transaction fees, particularly those that are filed with the Commission for approval.<sup>188</sup> Finally, a few commenters questioned the Commission’s authority to set limitations on access fees.<sup>189</sup>

The Commission acknowledges the many difficult issues associated with access fees, but is concerned that these issues must be resolved to promote a fair and efficient NMS, particularly under the reproposed regulatory structure. As the SIA noted while discussing the divergent views of its members both opposing and supporting access fees, “[p]erhaps the only point of agreement in this debate is a desire for the resolution of the issue.”<sup>190</sup>

After considering the many divergent views of commenters, the Commission preliminarily believes that a flat limitation on access fees to \$0.003 per share would be the fairest and most appropriate solution to what has been a longstanding and contentious issue.<sup>191</sup> The limitation is intended to achieve several objectives. First, it would greatly simplify the proposal by eliminating the separate limitations for trading centers and liquidity providers, as well as the associated attribution requirement. A single accumulated fee cap would apply

equally to all types of trading centers and all types of market participants, thereby promoting the NMS objective of equal regulation of markets and broker-dealers.<sup>192</sup>

Second, the \$0.003 fee limitation would be consistent with current business practices, as very few trading centers charge fees that exceed this amount.<sup>193</sup> Based on recent inquiries, it appears that only two ECNs currently charge fees that exceed \$0.003. One charges \$0.004 for access through ADF, and the other charges \$0.009 for access through the ADF. Neither of these ECNs currently accounts for a large percentage of trading volume. In addition, a few SROs have large fees on their books for transactions in ETFs that exceed a certain size (e.g., 2100 shares). It is unlikely that these fees generate a large amount of revenues.

Accordingly, the reproposed fee limitation would *not* reduce, much less eliminate, the fees that currently are charged by agency markets. The Commission recognizes that agency trading centers perform valuable agency services in bringing buyers and sellers together, and that their business model historically has relied, at least in part, on charging fees for execution of orders against their displayed quotations. Prohibiting access fees entirely would unduly harm this business model.

Although not intended to reduce access fees, the reproposed fee limitation would be designed to preclude individual trading centers from raising their fees substantially in an attempt to take improper advantage of strengthened protection against trade-throughs and the adoption of a private linkage regime. In particular, the reproposed fee limitation would be necessary to address “outlier” trading centers that otherwise might charge high fees and pass most of the fees through as rebates to attract liquidity providers. It also would preclude a trading center from charging high fees selectively to competitors, practices that have arisen in the market for Nasdaq stocks, with limited success. In the absence of a fee limitation, however, the adoption of the Trade-Through Rule and private linkages could significantly boost the viability of the outlier business model. Outlier markets might well try to take advantage of intermarket price protection by acting essentially as a toll booth between price levels. The high fee market likely would be the last market

to which orders would be routed, but prices could not move to the next level until someone routed an order to take out the displayed price at the outlier market. Because an outlier market could be no worse than last in order-routing preference, no matter how high its fees, it might see little downside to charging exceptionally high fees, such as \$0.009, and passing most of the fee on to liquidity providers as rebates. In sum, while markets would have significant incentives to compete to be near the top in order-routing priority,<sup>194</sup> there might be little incentive to avoid being the least-preferred market if fees were not limited.

The \$0.003 cap would preclude the outlier business model. It would place all markets on a level playing field in terms of the fees they can charge and the rebates they can pass on to liquidity providers. Some markets might choose to charge lower fees, thereby increasing their ranking in the preferences of order routers. Others might charge the full \$0.003 and rebate a substantial proportion to liquidity providers. Competition would determine which strategy was most successful.

Moreover, the fee limitation would be necessary to achieve the purposes of the Exchange Act. Access fees tend to be highest when markets use them to fund substantial rebates to liquidity providers, rather than merely to compensate for agency services. If outlier markets were allowed to charge exorbitant fees and pass most of them through as rebates, the published quotations of such markets would not reliably indicate the true price that is actually available to investors or that would be realized by liquidity providers. Section 11A(c)(1)(B) of the Exchange Act authorizes the Commission to adopt rules assuring the fairness and usefulness of quotation information. For quotations to be fair and useful, there must be some limit on the extent to which the true price for those who access quotations, and the true price realized by those who supply liquidity for quotations, can vary from the displayed price. Consequently, the \$0.003 fee limitation would further the statutory purposes of the NMS by harmonizing quotation practices and precluding the distortive effects of exorbitant fees and liquidity rebates. Moreover, the fee limitation would be needed to further the statutory purpose of enabling broker-dealers to route orders in a manner consistent with the

<sup>186</sup> See, e.g., Brut Letter at 12; Instinet Letter at 24; SIA Letter (some firms) at 18.

<sup>187</sup> Instinet Letter at 27.

<sup>188</sup> See, e.g., Amex Letter at 7–8; Goldman Sachs Letter at 5; Knight Letter at 2; NYSE Letter at 5; STA Letter at 6.

<sup>189</sup> See, e.g., Instinet Letter at 24; Letter from Roderick Covlin, Executive Vice President, TrackECN, to William H. Donaldson, Chairman, Commission, dated May 10, 2004 (“TrackECN Letter”) at 1.

<sup>190</sup> SIA Letter at 17.

<sup>191</sup> For the relatively small number of NMS stocks priced under \$1.00, fees would be limited to 0.3% of the quotation price per share to prevent fees from constituting an excessive percentage of share price.

<sup>192</sup> Section 11A(c)(1)(F) of the Exchange Act.

<sup>193</sup> Cf. Instinet Letter at 38 (“there is no basis for adopting any limitation other than at the prevailing \$0.003 per share level, which was arrived at through open competition among ATSS, ECNs, and SRO markets in the Nasdaq market”).

<sup>194</sup> See *supra*, section II.A.4.a (discussion of competitive implications of trade-through protection).

operation of the NMS.<sup>195</sup> To protect limit orders, orders must be routed to those markets displaying the best-priced quotations. This purpose would be thwarted if market participants were allowed to charge exorbitant fees that distort quoted prices.

Finally, the access fee limitation is narrowly drafted to cover only quotations that market participants would be required to access because of the Trade-Through Rule. The limitation would not apply to depth-of-book quotations (unless such quotations were designated as protected quotations under the Voluntary Depth Alternative) or to any other services offered by markets. It thereby would provide the necessary support for proper functioning of the Trade-Through Rule and private linkages, while leaving trading centers otherwise free to set fees subject only to other applicable standards (e.g., prohibiting unfair discrimination).

### 3. Locking or Crossing Quotations

The access proposal provided that the SROs must establish and enforce rules (1) requiring their members reasonably to avoid posting quotations that lock or cross the quotations of other markets, (2) enabling the reconciliation of locked or crossed markets, and (3) prohibiting their members from engaging in a pattern or practice of locking or crossing quotations. In light of the discussion at the NMS Hearing concerning automated quotations and automated markets,<sup>196</sup> the Supplemental Release requested comment on whether market participants should be allowed to submit automated quotations that lock or cross manual quotations.<sup>197</sup>

Most of the commenters who addressed the issue supported the proposed restrictions on locking and crossing quotations.<sup>198</sup> They generally agreed that the practice of displaying quotations that lock or cross previously displayed quotations is inconsistent with fair and orderly markets and detracts from market efficiency. One noted, for example, that locked and

crossed markets “can be a sign of an inefficient market structure” and “may create confusion for investors, as it is unclear under such circumstances what is the true trading interest in a stock.”<sup>199</sup> Some commenters asserted that locked markets often occur when a market participant deliberately posts a locking quotation to avoid paying a fee to access the quotation of another market and to receive a liquidity rebate for an execution against its own displayed quotation.<sup>200</sup> Nasdaq submitted data regarding the frequency of locked and crossed markets. During a one-week period in March 2004, it found that markets for Nasdaq stocks were locked or crossed an average of 509,018 times each day, with an average of 194,638 of the locks and crosses lasting more than 1 second and an average duration of all locks and crosses of 3.1 seconds.<sup>201</sup> Nasdaq stocks currently are not subject to provisions discouraging intermarket locking or crossing quotations such as those contained in the ITS Plan.

A few commenters opposed restricting the practice of locking or crossing quotations.<sup>202</sup> They generally believed that the proposal would impair market transparency and efficiency, such as by prohibiting the display of information as to the true level of trading interest or information that a particular market’s quotations may be inaccessible. One commenter identified a number of causes, apart from access fees and liquidity rebates, that could lead to locked and crossed markets.<sup>203</sup> These included determinations by market participants that quotations displayed by a locked or crossed market are not truly accessible, decisions by market participants that the potential disadvantages of routing away outweigh the potential advantages (e.g., loss of execution priority on the market place currently displaying the order), and decisions by market participants to exclusively use a particular market to run a trading strategy, even at the risk of missing some trading opportunities.

The Commission has decided to repropose restrictions on the practice of displaying locking or crossing

quotations, but, consistent with its approach in the repropose Trade-Through Rule, has modified the proposal to allow automated quotations to lock or cross manual quotations. Rule 610(d) as repropose thereby would address the concern that manual quotations may not be fully accessible and would recognize that allowing automated quotations to lock or cross manual quotations may provide useful market information. The Commission preliminarily believes, however, that an automated quotation is entitled to protection from locking or crossing quotations. When two market participants are willing to trade at the same quoted price, giving priority to the first-displayed automated quotation would contribute to fair and orderly markets. Moreover, the basic principle underlying the NMS is to promote fair competition among markets, but within a unified system that also promotes interaction between all of the buyers and sellers in a particular NMS stock. Allowing market participants simply to ignore accessible quotations in other markets and routinely display locking and crossing quotations would be inconsistent with this principle.

### B. Description of Reproposed Rule

Paragraphs (a) and (b) of repropose Rule 610 address access to all quotations displayed by an SRO trading facility or by an SRO display-only facility. Paragraph (c) addresses the fees charged for access to protected quotations, and paragraph (d) addresses locking and crossing quotations. The Commission also is repropose an extension of the scope of the fair access requirements of Regulation ATS.

#### 1. Access to Quotations

a. Quotations of SRO Trading Facilities. Paragraph (a) of repropose Rule 610 applies to quotations of an SRO trading facility. In repropose Rule 600(b)(72), an SRO trading facility is defined as a facility operated by a national securities exchange or a national securities association that executes orders in securities or presents orders to members for execution.<sup>204</sup> This definition therefore would encompass the trading facilities of each of the exchanges, as well as the NASDAQ Market Center. The term “quotations” is defined in repropose Rule 600(b)(63) as bids and offers, and “bid” or “offer” is defined in repropose Rule 600(b)(8) as the bid

<sup>204</sup> For clarity, the definition of “SRO trading facility” replaces the definition of “quoting market center” in the proposal. It is consistent with the old definition.

<sup>195</sup> Section 11A(c)(1)(E) of the Exchange Act authorizes the Commission to adopt rules assuring that broker-dealers transmit orders for NMS stocks in a manner consistent with the establishment and operation of a national market system.

<sup>196</sup> See *supra*, section II.A.2.

<sup>197</sup> Supplemental Release, 69 FR at 30147.

<sup>198</sup> Amex Letter, Exhibit A at 27–28; Letter from Steve Swanson, Chief Executive Officer & President, Automated Trading Desk, LLC, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 (“ATD Letter”) at 3; Brut Letter at 17; BSE Letter at 13; Citigroup Letter at 14; E\*Trade Letter at 10; ICI Letter at 18; JP Morgan Letter at 6; Nasdaq Letter II at 23–24; NYSE Letter, Attachment at 9; SIA Letter at 19–20; STA Letter at 6; STANY Letter at 8; UBS Letter at 9–10.

<sup>199</sup> ICI Letter at 18.

<sup>200</sup> Amex Letter, Exhibit A at 27–28; ATD Letter at 3; ICI Letter at 18; Nasdaq Letter II at 23.

<sup>201</sup> Nasdaq Letter II at 23.

<sup>202</sup> Letter from Linda Lerner, General Counsel, Domestic Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated September 9, 2004 (“Domestic Securities Letter”) at 2–3; Hudson River Trading Letter at 5–6; Instinet Letter at 39–41; Letter from Michael J. Simon, Senior Vice President & Secretary, International Securities Exchange, Inc., to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 (“ISE Letter”) at 7–8; Tower Research Letter at 6–8.

<sup>203</sup> Instinet Letter at 39.

price or the offer price communicated by a member of a national securities exchange or national securities association to any broker or dealer or to any customer. Reproposed Rule 610(a) therefore would apply to the entire depth of book of displayed orders of an SRO trading facility.

Reproposed Rule 610(a) would prohibit an SRO from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member of the SRO to the quotations in an NMS stock displayed by the SRO trading facility. This anti-discrimination standard is designed to give non-members indirect access to quotations through members, but is premised on the fact that the SRO's members themselves have fair and efficient access to the quotations of the SRO's trading facility. Such access currently is addressed by a series of provisions of the Exchange Act. Sections 6(b)(1) and 15A(b)(2) require that an exchange or association must have the capacity to be able to carry out the purposes of the Exchange Act. Sections 6(b)(5) and 15A(b)(6) require an exchange or association to have rules designed to remove impediments to and perfect the mechanism of a free and open market and a national market system. Section 11A(a)(1)(C) provides that two of the objectives of a national market system are to assure the economically efficient execution of securities transactions and the practicability of brokers executing investors' orders in the best market. Neither of these objectives is possible if an SRO's members—those entities that have the right to trade directly on an SRO facility—do not themselves have fair and efficient access to the quotations displayed on such facility.

Reproposed Rule 610(a) would build on this existing regulatory structure by prohibiting unfair discrimination that prevents or inhibits non-members from piggybacking on the access of members. In the absence of mandatory public linkages directly between markets, the ability to obtain indirect access is necessary to assure that competing markets can meet the requirements of the Trade-Through Rule and that all brokers can fulfill their duty of best execution. In general, any SRO rule or practice that treats orders less favorably based on the identity of the ultimate party submitting the order through an SRO member would violate repropoed Rule 610(a). Thus, for example, charging differential fees or reducing an order's priority based on the identity of a member's customer would violate repropoed Rule 610(a).

Given the critical importance of indirect access to the private linkage approach incorporated in repropoed Rule 610(a), the Commission intends to review the current extent to which SRO members have fair and efficient access to quotations in NMS stocks that are displayed on an SRO trading facility, which term does not include the NASD's ADF, as discussed below. In this regard, it emphasizes that the SROs cannot meet the access requirements of the Exchange Act by relying on access provided by trading centers that are not a facility operated by the SRO. Thus, if a trading center displays quotes on an SRO trading facility, but also provides direct access to such quotes, that SRO could not rely on the level of direct access to the non-SRO trading center to meet its Exchange Act responsibilities. An SRO trading facility must itself provide fair and efficient access to the quotations that are displayed as quotations of such SRO. Stated another way, an SRO trading facility cannot be used simply as a conduit for the display of quotations that cannot be accessed fairly and efficiently through the SRO trading facility itself. Accordingly, each SRO's facilities would be reviewed to determine whether they were able to meet the enhanced need for access under the repropoed regulatory structure.

b. Quotations of SRO Display-Only Facility. Paragraph (b) of repropoed Rule 610 would apply to all quotations displayed by an SRO display-only facility. The term "SRO display-only facility" is defined in repropoed Rule 600(b)(71) as a facility operated by a national securities exchange or national securities association that displays quotations in securities, but does not execute orders against such quotations. For quotations in NMS stocks, this definition currently would encompass only the NASD's ADF.<sup>205</sup>

Paragraph (b)(1) of repropoed Rule 610 would require any trading center that displays quotations in NMS stocks through an SRO display-only facility to provide a level and cost of access to such quotations that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading

facilities. The phrase "level and cost of access" would encompass both (1) the policies, procedures, and standards that govern access to quotations of the trading center, and (2) the connectivity through which market participants can obtain access and the cost of such connectivity. As discussed in section III.A.1 above, trading centers that choose to display quotations in an SRO display-only facility would be required to bear the responsibility of establishing the necessary connections to afford fair and efficient access to their quotations. The nature and cost of these connections for market participants seeking to access the trading center's quotations would need to be substantially equivalent to the nature and cost of connections to SRO trading facilities. In recent years, a variety of different types of entities have entered the business of providing connections for brokers and market participants to different trading centers. The Commission anticipates that ADF participants would take advantage of these service providers to establish the necessary connectivity. The NASD, as the self-regulatory authority responsible for enforcing compliance by ADF participants with the requirements of the Exchange Act, would need to evaluate the connectivity of ADF participants to determine whether it meets the requirements of Rule 610(b)(1).

Paragraph (b)(2) of repropoed Rule 610 would prohibit any trading center that displays quotations through an SRO display-only facility from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access to such quotations through a member, subscriber, or customer of the trading center. This prohibition parallels the prohibition in repropoed Rule 610(a) that applies to the quotations of SRO trading facilities. Thus, a trading center's differential treatment of orders based on the identity of the party ultimately submitting an order through a member, subscriber, or customer of such trading center generally would be prohibited.

## 2. Limitation on Access Fees

Repropoed Rule 610(c) would limit the fees that could be charged for access to protected quotations. It provides that a trading center shall not impose, nor permit to be imposed, any fee or fees for the execution of orders against its protected quotations in an NMS stock that exceed or accumulate to more than \$0.003 per share or, for its protected quotations with a price of less than \$1.00, that exceed or accumulate to

<sup>205</sup> As proposed, the indirect access requirement for ADF participants would have applied only to trading centers whose quotations were *solely* accessible in the ADF and not through an SRO trading facility. As repropoed, Rule 610(b)(1) applies to all quotations displayed on an SRO display-only facility, even if the trading center also displays quotations in an SRO trading facility. This modification is needed to preclude the consolidated data stream from giving a misleading indication of available liquidity. Separate quotations displayed on an SRO trading facility and an SRO display-only facility must each be fully accessible.

more than 0.3% of the quotation price per share.

Thus, the scope of repropoed Rule 610(c) would be limited to quotations protected by the Trade-Through Rule. Under the alternative definitions of "protected bid" and "protected offer" repropoed for Rule 600(b)(57), the fee limitation would apply, at a minimum, to an automated quotation that is the BBO of an exchange, the NASDAQ Market Center, or the ADF. If the Voluntary Depth Alternative were adopted and markets voluntarily obtained protection for their depth-of-book quotations, the fee limitation also would apply to orders accessing these quotations.<sup>206</sup> When triggered, the fee limitation of Rule 610(c) would apply to any order execution at the displayed price of the protected quotation. It therefore would encompass executions against both the displayed size and any reserve size at the price of a protected quotation.

Repropoed Rule 610(c) would encompass a wide variety of fees currently charged by trading centers, including both the fees commonly known as access fees charged by ECNs and the transaction fees charged by SROs. So long as the fees are based on the execution of an order against a protected quotation, the restriction of repropoed Rule 610(c) would apply. Conversely, fees not triggered by the execution of orders against protected quotations (e.g., certain periodic fees such as monthly or annual fees) generally would not be included.

In addition, repropoed Rule 610(c) would encompass any fee charged directly by a trading center, as well as any fee charged by market participants that display quotations through the trading center's facilities. Trading centers would have flexibility in establishing their fee schedules to comply with repropoed Rule 610(c). In particular, trading centers could impose a limit on the fees that market participants are permitted to charge for quotations that are accessed through a trading center's facilities. For example, Nasdaq has adopted such a limit for quotations displayed by the NASDAQ Market Center.<sup>207</sup>

If repropoed Rule 610(c) were adopted, market makers would be permitted to charge fees for accessing their quotations, so long as such fees met the Rule's requirements. Market makers currently are not permitted to charge access fees under the Quote Rule. To promote the equal regulation of

markets, the Commission preliminarily believes that, if repropoed Rule 610(c) were adopted, it would be consistent with the Quote Rule for market makers to charge access fees. In particular, market makers would be permitted to charge fees for executions of orders against their protected quotations irrespective of whether the order executions are effected on an SRO trading facility or directly by the market maker.

### 3. Locking or Crossing Quotations

Repropoed Rule 610(d) would restrict locking or crossing quotations, but would recognize that locked and crossed markets can occur accidentally, especially given the differing speeds with which trading centers update their quotations. It would require that each national securities exchange and national securities association establish and enforce rules that: (1) Require its members to reasonably avoid displaying quotations that lock or cross any protected quotation in an NMS stock, or of displaying manual quotations that lock or cross any quotation in an NMS stock disseminated pursuant to an effective national market system plan; (2) are reasonably designed to assure the reconciliation of locked or crossed quotations in an NMS stock; and (3) prohibit its members from engaging in a pattern or practice of displaying quotations that lock or cross any protected quotation in an NMS stock, or of displaying manual quotations that lock or cross any quotation in an NMS stock disseminated pursuant to an effective national market system plan.

Thus, repropoed Rule 610(d) would distinguish between protected (and therefore automated)<sup>208</sup> quotations and manual quotations. Protected quotations could not be crossed or locked by any other quotations. Manual quotations, in contrast, could be locked or crossed by automated quotations, but could not themselves lock or cross any other quotations included in the consolidated data stream, whether automated or manual. Recognizing that quotations may on occasion accidentally lock or cross other quotations, repropoed Rule 610(d) would require members to "reasonably avoid" locking and crossing and prohibits a "pattern or practice" of locking or crossing. SRO rules could include so-called "ship and post" procedures that require a market participant to attempt to execute against a relevant displayed quotation while posting a quotation that could lock or cross such a quotation. Finally,

repropoed Rule 610(d)(2) would require that each SRO's rules be reasonably designed to enable the reconciliation of locked or crossed quotations in an NMS stock. Such rules would require the market participant responsible for displaying the locking or crossing quotation to take reasonable action to resolve the locked or crossed market.

### 4. Regulation ATS Fair Access

The "fair access" standards of Rule 301(b)(5) of Regulation ATS<sup>209</sup> require a covered ATS, among other things, to (1) establish written standards for granting access on its system, and (2) not unreasonably prohibit or limit any person in respect to services offered by the ATS by applying its access standards in an unfair or discriminatory manner. The Commission is repropoing an amendment to this section of Regulation ATS to lower the threshold that triggers the Regulation ATS fair access requirements from 20% of the average daily volume in a security to 5%.<sup>210</sup> Under the access approach repropoed today, the fairness and efficiency of private linkages would assume heightened importance. A critical component of private linkages is the ability of interested market participants to become members or subscribers of a trading center, particularly those trading centers with significant trading volume. As discussed in section III.A.1 above, market participants then may use their membership or subscribership access as a means for others to obtain indirect access by piggybacking on the direct access of members or subscribers. The Commission therefore believes that it would be appropriate to lower the fair access threshold of Regulation ATS.<sup>211</sup> Lowering the threshold for paragraph (b)(5) of Rule 301 also would make its coverage consistent with the 5% threshold triggering the order display and execution access requirements of Rule 301(b)(3). As a result, each ATS required to disseminate its quotations in the consolidated data stream also would be prohibited from unreasonably

<sup>209</sup> 17 CFR 242.301(b)(5).

<sup>210</sup> The Regulation ATS fair access requirements are triggered on a security-by-security basis for equity securities. See Securities Exchange Act Release No. 40760 (Dec. 8, 1998), 63 FR 70844, 70873 (Dec. 22, 1998).

<sup>211</sup> One commenter opposed the proposal to lower the threshold for Regulation ATS fair access, primarily because it largely acts as an agency broker that routes orders to other venues. Bloomberg Tradebook Letter at 7. The Commission preliminarily believes that ATSs, which by definition has chosen to offer market functions beyond mere agency routing, would appropriately be subject to regulatory requirements that reflect such functions.

<sup>206</sup> See *supra*, section II.A.5 (scope of quotations protected by repropoed Trade-Through Rule).

<sup>207</sup> NASD Rule 4623(b)(6).

<sup>208</sup> Under Rule 600(b)(57), only automated quotations can qualify as protected quotations.

limiting market participants from becoming a subscriber or customer. Aside from lowering the threshold, the substantive requirements of Rule 301(b)(5) would be left unchanged.

#### IV. Sub-Penny Rule

The Commission today is reproposing Rule 612 under the Exchange Act which would govern sub-penny quoting of NMS stocks. Rule 612 would impose new requirements on any bid, offer, order, or indication of interest that is displayed, ranked, or accepted by a national securities exchange, national securities association, ATS, vendor, or broker-dealer. The reproposed rule incorporates the substance of the initially proposed rule with a few minor revisions, as discussed below.

##### A. Background

In June 2000, the Commission issued an order directing NASD and the national securities exchanges to act jointly in developing a plan to convert their quotations in equity securities and options from fractions to decimals.<sup>212</sup> The June 2000 Order stated that the plan could fix the minimum price variation ("MPV") during the phase-in period, provided that the MPV was no greater than \$0.05 and no less than \$0.01 for any equity security.<sup>213</sup> The June 2000 Order also required NASD and the exchanges to provide the Commission with studies analyzing how decimal conversion had affected systems capacity, liquidity, and trading behavior, including an analysis of whether there should be a uniform MPV.<sup>214</sup> The Commission stated that, if NASD or an exchange wished to move to quoting stocks in an increment less than \$0.01, its study should include a full analysis of the potential impact on the market requesting the change and on the markets as a whole.<sup>215</sup> Furthermore, the Commission required each SRO to

propose a rule change under Section 19(b) of the Exchange Act<sup>216</sup> to establish its individual choice of MPV for securities traded on its market.<sup>217</sup> NASD and the exchanges complied with these requirements, and in August 2002 the Commission approved rule changes from all of these SROs to establish MPVs in NMS stocks of \$0.01.<sup>218</sup>

Between the June 2000 Order and the August 2002 Order, the Commission issued a Concept Release seeking public comment on the potential impact of sub-penny pricing,<sup>219</sup> including its effect on: (1) Price clarity (*e.g.*, the potential to cause ephemeral or "flickering" quotations); (2) market depth (*i.e.*, the number of shares available at a given price); (3) compliance with the Order Handling Rules and other price-dependent rules; and (4) the operations and capacity of automated systems.<sup>220</sup> The Commission received 33 comments on the Concept Release.<sup>221</sup> The majority of commenters opposed sub-penny pricing. Some stated that the negative effects of decimal trading would be exacerbated by reducing the MPV even further, without meaningfully reducing spreads or securing other benefits for the markets or investors.<sup>222</sup> These commenters recommended that all securities have an MPV of at least a penny.<sup>223</sup> A smaller number of commenters believed that the forces of competition, rather than regulation by the Commission or Congress, should determine the MPV.<sup>224</sup> These commenters suggested that a smaller MPV could improve market efficiency and provide investors with greater opportunity for price improvement. They argued in general that the problems accompanying decimals could be resolved through technology enhancements, rather than through regulation.

In August 2003, Nasdaq submitted a proposed rule change to the Commission to adopt an MPV of \$0.001

for Nasdaq-listed securities.<sup>225</sup> Nasdaq stated that, unless and until a uniform MPV is established, it believed it must implement an MPV of \$0.001 to remain competitive with ECNs that permit their subscribers to quote in sub-pennies. Simultaneous with the proposed rule change, Nasdaq filed a petition for Commission action urging the Commission "to adopt a uniform rule requiring market participants to quote and trade Nasdaq securities in a consistent monetary increment \* \* \* with the exception of average price trades."<sup>226</sup>

##### B. Commission Proposal on Sub-Penny Quoting

In February 2004, the Commission proposed new Rule 612 that would govern quoting in sub-pennies as part of the overall Regulation NMS proposal. In the Proposing Release, the Commission summarized the conversion of the U.S. securities markets from fractional to decimalized trading and stated its view that, on balance, the benefits of decimalization have justified the costs. The Commission cautioned, however, that if the MPV decreases beyond a certain level the potential costs to investors and the markets might increase and could at some point surpass any potential benefits.<sup>227</sup> To address this concern, proposed Rule 612 would prohibit any national securities exchange, national securities association, ATS, vendor, or broker-dealer from displaying, ranking, or accepting from any person bid, offer, order, or indication of interest in any NMS stock priced in an increment less than \$0.01. Proposed Rule 612 would not impose this restriction on any NMS stock the share price of which is below \$1.00.

The proposed rule was designed to limit the ability of a market participant to gain execution priority by bettering the price of another limit order by an economically insignificant amount. In issuing the sub-penny proposal, the Commission cited research performed by OEA strongly suggesting that much sub-penny quoting currently taking place results from market participants attempting to step ahead of limit orders for the smallest economic increment possible.<sup>228</sup> This conclusion was based on the high incidence of sub-penny

<sup>212</sup> See Securities Exchange Act Release No. 42194 (June 8, 2000), 65 FR 38010 (June 19, 2000) ("June 2000 Order"). On January 28, 2000, the Commission ordered NASD and the exchanges to facilitate an orderly transition to decimal pricing in the securities markets. See Securities Exchange Act Release No. 42360 (Jan. 28, 2000), 65 FR 5003 (Feb. 2, 2000). In that order, the Commission set a timetable for NASD and the exchanges to begin trading some equity securities, and options on those securities, in decimals by July 3, 2000, and to begin trading all equities and options by January 3, 2001. See January 2000 Order, 65 FR at 5005. In April 2000, the Commission issued another order staying the original deadlines for decimalization. See Securities Exchange Act Release No. 42685 (Apr. 13, 2000), 65 FR 21046 (Apr. 19, 2000).

<sup>213</sup> See June 2000 Order, 65 FR at 38013. The June 2000 Order also required that at least some equity securities be quoted in minimum increments of \$0.01. See *id.*

<sup>214</sup> See *id.*

<sup>215</sup> See *id.*

<sup>216</sup> 15 U.S.C. 78s(b).

<sup>217</sup> See June 2000 Order, 65 FR at 38013.

<sup>218</sup> See Securities Exchange Act Release No. 46280 (July 29, 2002), 67 FR 50739 (Aug. 5, 2002) ("August 2002 Order") (approving SR-Amex-2002-02, SR-BSE-2002-02, SR-CBOE-2002-02, SR-CHX-2002-06, SR-CSE-2002-02, SR-ISE-2002-06, SR-NASD-2002-08, SR-NYSE-2002-12, SR-PCX-2002-04, and SR-Phlx-2002-05).

<sup>219</sup> Securities Exchange Act Release No. 44568 (July 18, 2001), 66 FR 38390 (July 24, 2001) ("Concept Release").

<sup>220</sup> See 66 FR at 38391-95.

<sup>221</sup> For a list of the commenters, see Proposing Release, 69 FR at 11165.

<sup>222</sup> See *id.*

<sup>223</sup> However, some commenters that opposed sub-penny quoting thought that trading in sub-pennies should be permitted. See *id.*

<sup>224</sup> See *id.* at 11165-66.

<sup>225</sup> See SR-NASD-2003-121. Nasdaq has since withdrawn this proposal.

<sup>226</sup> Letter to Jonathan G. Katz, Secretary, Commission, from Edward S. Knight, Executive Vice President, Nasdaq, dated August 4, 2003 ("Nasdaq Petition").

<sup>227</sup> See Proposing Release, 69 FR at 11165.

<sup>228</sup> See 69 FR at 11169-70.



trades that cluster around the \$0.001 and \$0.009 price points.

In the Proposing Release, the Commission pointed to a variety of potential problems caused by sub-penny quoting, including the following:

- If investors' limit orders lose execution priority for a nominal amount, investors may over time decline to use them, thus depriving the markets of liquidity.

- When market participants can gain execution priority for an infinitesimally small amount, important customer protection rules such as exchange priority rules and NASD's Manning rule<sup>229</sup> could be rendered meaningless. Without these protections, professional traders would have more opportunity to take advantage of non-professionals, which could result in the latter either losing executions or receiving executions at inferior prices.

- Flickering quotations that can result from widespread sub-penny pricing could make it more difficult for broker-dealers to satisfy their best execution obligations and other regulatory responsibilities. The best execution obligation requires a broker-dealer to seek for its customer's transaction the most favorable terms reasonably available under the circumstances.<sup>230</sup> This standard is premised on the practical ability of the broker-dealer to determine whether a displayed price is reasonably obtainable under the circumstances.

- Widespread sub-penny quoting could decrease market depth (*i.e.*, the number of shares available at the NBBO). This could lead to higher transaction costs, particularly for

institutional investors (such as pension funds and mutual funds), which are more likely to place large orders. These higher transaction costs would likely be passed on to retail investors whose assets are managed by the institutions.

- Decreasing depth at the inside also could cause such institutions to rely more on execution alternatives away from the exchanges and Nasdaq that are designed to help larger investors find matches for large blocks of securities. Such a trend could increase fragmentation of the securities markets.

### C. Comments Received

The Commission sought comment on all aspects of proposed Rule 612, including the potential problems with sub-penny quoting noted above. Of the comments that the Commission received in response to the Regulation NMS Proposing Release, approximately 60 separate commenters addressed the sub-penny proposal.

#### 1. Comments Addressing Overall Proposal

A majority of commenters supported the proposed sub-penny rule.<sup>231</sup> Several commenters concurred with the Commission's view that sub-penny quoting is widely used to step-ahead of competing limit orders.<sup>232</sup> One commenter, an ECN, stated that it carried out an informal survey of its buy-side clients, and of the 158 responses received 145 said that they opposed sub-penny quoting.<sup>233</sup> The ECN concluded that "[its] clients believe that quoting in sub pennies is used, not for bona fide price improvement, but to jump ahead of their limit orders."<sup>234</sup> Another commenter, a large discount brokerage firm, stated that it ceased allowing its clients to submit sub-penny orders in April 2003

"because it had determined that clients were using sub-pennies to step ahead of resting limit orders and undermining the Manning provision."<sup>235</sup> A third commenter stated that the reduction of the MPV has allowed "speculators" to post quotations at small increments ahead of institutional trading interest, resulting in decreased liquidity as such institutional interest began seeking methods of execution other than the posting of limit orders.<sup>236</sup>

Furthermore, the commenters supporting the Commission's sub-penny proposal were generally of the view that the marginal benefits of a further reduction in the MPV were not justified by the associated costs.<sup>237</sup> Several commenters argued, in essence, that "[a]n industry-wide shift to quoting in sub-pennies would \* \* \* require costly additional investments in systems capacity while producing little in the way of more efficient markets."<sup>238</sup> Several commenters also believed that sub-penny quotations increase the incidence of quote flickering, which in turn may have adverse effects such as creating investor confusion or impeding a broker-dealer's duty of best execution.<sup>239</sup>

However, a minority of commenters opposed the Commission's proposal to prohibit sub-penny quoting.<sup>240</sup> These commenters generally argued that the MPV should be determined by market forces. Two commenters believed that regulating quoting conventions would "prevent marketplaces from making subsequent innovative changes to their quotation increments to respond to the needs of investors"<sup>241</sup> and "legislate[] a maximum efficiency for the market instead of allowing further improvement."<sup>242</sup> Other commenters stated that quoting in sub-pennies can increase liquidity, lower trading costs,

<sup>229</sup> See NASD IM-2110-2 (generally requiring that a member firm that accepts and holds an unexecuted limit order from its customer in a Nasdaq security and that continues to trade the subject security for its own market-making account at prices that would satisfy the customer's limit order, without executing that limit order, shall be deemed to have acted in a manner inconsistent with just and equitable principles of trade). The impetus for this rule was a case brought by a customer of an NASD member firm, William Manning, who alleged that the firm had accepted his limit order, failed to execute it, and violated its fiduciary duty to him by trading ahead of the order. In the Manning decision, *In re E.F. Hutton & Co.*, Exchange Act Release No. 25887 (July 6, 1988), the Commission affirmed NASD's finding that a member firm, upon acceptance of a customer's limit order, undertakes a fiduciary duty to its customer and cannot trade for its own account at prices more favorable than the customer's order.

<sup>230</sup> See Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290, 48322 (Sept. 12, 1996) (adopting the Commission's Order Handling Rules). A broker-dealer's duty of best execution derives from common law agency principles and fiduciary obligations and is incorporated in both SRO rules and, through judicial and Commission decisions, in the antifraud provisions of the federal securities laws. See *id.*

<sup>231</sup> See, e.g., AFB Letter at 12; American Century Letter at 2; Ameritrade Letter at 10; Archipelago Letter at 14; ATD Letter at 3-4; Bloomberg Tradebook Letter at 2; BoNY Letter at 4; BSE Letter at 13-14; CBOE Letter at 7; Citadel Letter at 9; Citigroup Letter at 14-15; CSE Letter at 23; Denizkurt E-mail; E\*Trade Letter at 11; Financial Information Forum Letter at 2-3; Financial Services Roundtable Letter at 5-6; Florida State Board Letter at 2; Goldman Sachs Letter at 10; ICI Letter at 19-20; ISE Letter at 8; JP Morgan Letter at 6-7; Knight Letter at 7-8; Lava Trading Letter at 5; Lehman Brothers Letter at 5; Liquidnet Letter at 8; LSC Letter at 11; Morgan Stanley Letter at 3; Nasdaq Letter at 1-2; NYSE Letter at 9-10; NSX Letter at 9; Peake I Letter at 13; Reuters Letter at 4; Schwab Letter at 17; SIA Letter at 20-21; Specialist Assoc. Letter at 13-15; STA Letter at 7; STANY Letter at 13-14; UBS Letter at 10; Vanguard Letter at 6.

<sup>232</sup> See, e.g., Ameritrade Letter at 10; Archipelago Letter at 14; ATD Letter at 3; Bloomberg Tradebook Letter at 2; Citadel Letter at 9; Citigroup Letter at 14; ICI Letter at 7-8; Tullo Letter at 8.

<sup>233</sup> See Bloomberg Tradebook Letter at 2.

<sup>234</sup> *Id.*

<sup>235</sup> Ameritrade Letter at 10.

<sup>236</sup> See Tullo Letter at 8.

<sup>237</sup> See, e.g., Citigroup Letter at 14; LSC Letter at 11; STA Letter at 7; STANY Letter at 10-11.

<sup>238</sup> Reuters Letter at 4. See also Financial Information Forum Letter at 2-3; Financial Services Roundtable Letter at 6; Knight Letter at 7; Lehman Brothers Letter at 5.

<sup>239</sup> See, e.g., Citadel Letter at 9; ICI Letter at 7; Knight Letter at 7; Reuters Letter at 4; SIA Letter at 20-21.

<sup>240</sup> See Brut Letter at 24; Domestic Securities Summary of Intended Testimony (no page numbers); GETCO Letter (no page numbers); Hudson River Trading Meeting Memo (no page numbers); Instinet Letter at 50; King Letter at 1; Mercatus Center Letter at 7; NexTrade Letter at 9-10; Reg NMS Study Group Letter at 9; Tower Research Letter at 8; Vie Securities Letter at 3.

<sup>241</sup> Instinet Letter at 50.

<sup>242</sup> E-mail from John Martello, Managing Director, Tower Research Capital LLC, to *rule-comments@sec.gov*, dated March 26, 2004.

and promote efficient pricing in the equity markets.<sup>243</sup>

These commenters generally argued that regulation was not necessary to remedy any perceived abuses caused by sub-penny quoting. Two commenters noted that some trading markets already have abandoned sub-penny quoting.<sup>244</sup> Another commenter added that “[t]he problems attributed to subpenny quoting have been largely cleared up by the market, and are likely to further improve if the Commission removes some uncertainty from the marketplace by withdrawing its proposal.”<sup>245</sup> This commenter also criticized the Nasdaq and OEA studies on which the Commission relied in issuing the sub-penny proposal.<sup>246</sup>

Under repropoed Rule 612, the minimum spread for most NMS stocks would be \$0.01. Two commenters stated that, as a result, investors would suffer harm from artificially widened spreads.<sup>247</sup> Another commenter stated that “the primary result of eliminating subpenny trading would be to preserve a minimum profit for market makers, and would result in significantly worse realized prices for the vast majority of market participants not in the business of making markets.”<sup>248</sup> This commenter analyzed trading in six high-volume securities and concluded that proposed Rule 612 would have costs of over \$400 million in these securities alone due to wider spreads.<sup>249</sup> Another commenter stated that, if all markets traded QQQQ solely in sub-pennies, the savings would be approximately \$150 million per year.<sup>250</sup>

In summary, the comments received have reinforced the Commission’s preliminary view that there are substantial drawbacks to allowing sub-penny quoting, and the Commission

<sup>243</sup> See Hudson River Trading Testimony (no page numbers); GETCO Letter (no page numbers).

<sup>244</sup> See Brut Letter at 24; Regulatory Studies Letter at 9.

<sup>245</sup> Tower Research Letter at 8.

<sup>246</sup> See *id.* Tower Research argued, for example, that the studies do not differentiate between sub-penny trades and sub-penny quotations and that clustering of sub-penny trades around the \$0.001 and \$0.009 price points could be the result of other activity, such as market makers offering sub-penny price improvement. In response to this comment, OEA reviewed the sources of data used in the original study and found that sub-penny trades cluster at these two price points in both markets where trades necessarily result from quotations, such as ECNs, and where that is not necessarily the case. Accordingly, OEA continues to believe that market participants frequently used their ability to quote in sub-pennies to step ahead of competing limit orders by the smallest possible amount.

<sup>247</sup> See Instinet Letter at 51; Mercatus Center Letter at 9.

<sup>248</sup> Tower Group Letter at 8.

<sup>249</sup> See *id.* at 9.

<sup>250</sup> See Instinet Letter at 50.

believes that a uniform rule prohibiting sub-penny quoting (except for quotations less than \$1.00) is appropriate in this case. Sub-penny quoting generally impedes transparency by reducing market depth at the NBBO and increasing quote flickering. In an environment where the NBBO can change very quickly, broker-dealers will have more difficulty in carrying out their duties of best execution and complying with other regulatory requirements that require them to identify the best bid or offer available at a particular moment (such as the Manning rule and the short sale rule).

The Commission preliminarily believes that the \$400 million and \$150 million estimates of the cost to the markets caused by wider spreads provided by commenters are inaccurate and excessive. These estimates appear to assume that all trading activity would occur at narrower quoted spreads. The Commission does not believe that the commenters provided any evidence to justify that assumption. Currently, no national securities exchange or national securities association permits quoting in sub-pennies; sub-penny quoting occurs on only a small number of ATSS. Because spreads on most markets already cannot be smaller than \$0.01, the Commission preliminarily does not believe that repropoed Rule 612 would require these markets to take any action that would cause their spreads to widen. Therefore, the Commission believes that the cost to these markets of not having sub-penny spreads should not be considered costs of the repropoed rule.<sup>251</sup>

Finally, the Commission agrees with the many commenters that believed that prohibiting sub-penny quoting will deter the practice of stepping ahead of exposed trading interest by an economically insignificant amount. Limit orders provide liquidity to the market and perform an important price-setting function. The Commission is concerned that, if a quotation or order can lose execution priority because of economically insignificant price improvement from a later-arriving quotation or order, liquidity could diminish and some market participants

<sup>251</sup> With respect to the ATSS that currently do permit some NMS stocks to be quoted in sub-pennies, the Commission staff has estimated that the costs of widened spreads in these securities would be approximately \$48 million annually (or approximately \$33 million if the Commission were to exempt QQQQ from repropoed Rule 612). See Memorandum to File from Office of Economic Analysis, dated December 15, 2004. A copy of this study has been placed in Public File No. S7-10-04 and is available for inspection on the Commission’s Internet Web site (<http://www.sec.gov/rules/proposed/s71004.shtml>).

could incur greater execution costs. As one commenter, the Investment Company Institute, stated, “[t]his potential for the increased stepping-ahead of limit orders would create a significant disincentive for market participants to enter any sizeable volume into the markets and would reduce further the value of displaying limit orders.”<sup>252</sup> Improved liquidity should decrease the costs of trading, especially for large orders, since larger size should be available at fewer price points than would exist in a sub-penny quoting environment.

The repropoed rule would make only minor changes to the initially proposed rule. Repropoed Rule 612(a) would prohibit sub-penny quotations in NMS stocks over \$1.00. Rule 612(b) would allow sub-penny quotations below \$1.00, but only to four decimal places. Rule 612(c) would establish procedures for the Commission to grant exemptions from paragraphs (a) and (b).

## 2. Response to Other Comments

Beyond addressing the general thrust of the proposed sub-penny rule, some commenters discussed more specific matters. The Commission has revised the proposed sub-penny rule in response to certain of these comments, as discussed below.

a. Restriction Based on Price of the Quotation not Price of the Stock. As initially proposed, the restriction on sub-penny quoting would be triggered if the price of the NMS stock itself were above \$1.00. One commenter sought clarification of when an NMS stock became sub-penny eligible, suggesting a threshold of trading below \$1.00 for 30 consecutive business days.<sup>253</sup> A second commenter suggested instead that the prohibition should derive from the price of the *order*, rather than the price of the *stock*; in other words, the rule should permit any sub-penny quotation below \$1.00 and prohibit any sub-penny quotation above \$1.00, regardless of the price level where the stock was in fact trading.<sup>254</sup> The second commenter argued that this approach “does not require countless re-classifications of stocks as ‘sub-penny eligible’ based on fluctuations in their valuation, stock splits, or other price movements.”<sup>255</sup>

The Commission agrees with the second commenter. Basing the restrictions on the price of the quotation or order rather than the price of the NMS stock itself would spare market participants the need to track the

<sup>252</sup> ICI Letter at 20.

<sup>253</sup> See Citigroup Letter at 15.

<sup>254</sup> See Brut Letter at 25.

<sup>255</sup> *Id.*

eligibility of stocks priced near the \$1.00 threshold. Accordingly, paragraph (a) of repropoed Rule 612 would prohibit bids, offers, orders, and indications of interest equal to or greater than \$1.00 in an increment smaller than \$0.01. Therefore, a market participant could not, for example, accept a sell order in an NMS stock priced at \$1.0025, even if the stock were trading below \$1.00. The Commission requests comment on the new approach taken in repropoed Rule 612(a).

b. Quotations Below \$1.00. The Commission initially proposed a threshold of \$1.00 below which the prohibition on sub-penny quoting would not apply and requested comment on whether that threshold was appropriate. The majority of commenters addressing this issue believed that it would be useful for low-priced securities to trade in increments finer than a penny, because a penny would constitute a significant percentage of the overall price. These commenters viewed \$1.00 as an appropriate threshold.<sup>256</sup> One commenter stated that there is “real demand for sub-penny trading (and therefore subpenny quoting) in securities trading below \$1.00, due to the low trading value of the security.”<sup>257</sup> The Commission agrees that sub-penny quotations for very low-priced securities largely represent genuine trading interest rather than an effort to step ahead of competing limit orders by an economically insignificant amount. In such cases, a sub-penny increment is more likely to represent a significant amount of the price of the quotation or order. Accordingly, the prohibition on sub-penny quoting in paragraph (a) of repropoed Rule 612 would apply only to bids, offers, orders, and indications of interest priced \$1.00 or greater.

Two commenters suggested that the Commission establish an MPV for quotations below \$1.00; both recommended allowing such quotations to extend to four decimal places.<sup>258</sup> The Commission agrees with these commenters and believes that it is reasonable to restrict quotations below \$1.00 to four decimal places. Accordingly, paragraph (b) of repropoed Rule 612 would prohibit bids, offers, orders, and indications of interest priced less than \$1.00 in an increment smaller than \$0.0001. Without the ability to quote very low-

priced securities in sub-pennies, market participants would be forced to express their trading interest in increments that represented a substantial portion of the overall quotation. However, if the number of decimal places for quotations in low-priced securities were not limited, the problems caused by sub-penny quoting of higher-priced securities, discussed above, could arise. Restricting quotations below \$1.00 to four decimal places would avoid these problems. Under repropoed Rule 612, a quotation of  $\$0.9987 \times \$1.00$  would be permissible but a quotation of  $\$0.9987 \times \$1.0001$  would not. The Commission requests comment on whether limiting quotations priced below \$1.00 to four decimal places is appropriate.

c. Revisiting the Penny Increment. Some commenters, while generally acknowledging problems caused by sub-penny quoting, recommended that the Commission consider increasing the MPV above \$0.01.<sup>259</sup> One commenter believed that “[t]he Commission should seriously consider experimenting with different tick sizes to help determine the optimal tick policy.”<sup>260</sup> A second commenter recommended that the Commission establish an MPV of a \$0.01 for high-volume stocks, \$0.05 middle-volume stocks, and \$0.10 for the low-volume stocks.<sup>261</sup> A third commenter stated that “sub-penny quoting does little, if anything, to degrade the market from its current state” because, in the commenter’s view, “the true damage was done to the market in the shift from a fractionalized environment to a penny spread environment.”<sup>262</sup>

Under repropoed Rule 612, the Commission would set a floor for the MPV, not determine the optimal MPV. Penny pricing was established by rules that were proposed by NASD and each of the national securities exchanges that trade NMS stocks and approved by the Commission pursuant to Section 19(b) of the Exchange Act.<sup>263</sup> While some commenters have raised liquidity concerns regarding the \$0.01 MPV, the move to decimals (and specifically the move to a penny MPV for equity securities) also has reduced spreads, thus resulting in reduced trading costs for investors entering orders—particularly smaller orders—that are executed at or within the quotations. Therefore, the Commission did not

propose a higher MPV as part of the initial Regulation NMS proposal. However, if the SROs in the future believe that an increase in the MPV is necessary or desirable, they may propose rule changes to institute the higher MPV. The Commission would evaluate those proposals under the requirements of the Exchange Act at that time.

d. Exemptions for Specific NMS Stocks. As initially proposed, Rule 612 included a provision that would establish procedures for the Commission to grant exemptions to the rule, and the Commission requested comment on whether certain securities should be exempted from Rule 612.<sup>264</sup> In particular, the Commission asked whether exchange-traded fund shares (“ETFs”), which are derivatively priced, raise the same concerns that have been expressed with respect to sub-penny pricing generally.<sup>265</sup>

Of the commenters who addressed this issue, the majority argued that the sub-penny prohibition should apply to all NMS stocks, including ETFs.<sup>266</sup> These commenters generally believed that sub-penny quoting raises the same type of concerns for ETFs as for other types of securities.<sup>267</sup> On the other hand, other commenters provided arguments that exemptions for at least certain securities would be appropriate. One commenter that opposed Rule 612 argued that, if the Commission nevertheless did approve the rule, it should provide an exemption for QQQQ and other ETFs.<sup>268</sup> This commenter argued that these securities “uniquely lend[] themselves to subpenny quoting and trading” because “the[ir] derivative nature \* \* \* enables investors to determine their true value at any point in time by calculating the aggregate price of the securities constituting a particular ETF.”<sup>269</sup> Other commenters, while not explicitly recommending that the Commission grant particular exemptions, argued that sub-penny quoting was reasonable for certain securities.<sup>270</sup> One of these commenters noted, for example, that quotations in QQQQ are not clustered around the \$0.001 and \$0.009 price points, which suggests that sub-penny quotations are

<sup>264</sup> See Proposing Release, 69 FR at 11172.

<sup>265</sup> See *id.*

<sup>266</sup> See Amex Letter, Exhibit A, at 29; ICI Letter at 20; Knight Letter at 8; Morgan Stanley Letter at 21; NYSE Letter at 10; SIA Letter at 21; Specialist Association Letter at 14.

<sup>267</sup> See, e.g., Amex Letter, Exhibit A, at 29; ICI Letter at 20.

<sup>268</sup> See Instinet Letter at 51.

<sup>269</sup> *Id.*

<sup>270</sup> See Brut Letter at 25; Mercatus Center Letter at 9–10; Tower Research Letter at 9, 14–15.

<sup>256</sup> See Archipelago Letter at 14; BSE Letter at 14; Citigroup Letter at 15; LSC Letter at 11; SIA Letter at 21; STANY Letter at 14.

<sup>257</sup> Archipelago Letter at 14.

<sup>258</sup> See Citigroup Letter at 15; SIA Letter at 21.

<sup>259</sup> See Amex Letter at 30; Angel Letter at 10; Anil Abraham Memo at 2; BoNY Letter at 4; Citadel Letter at 10; McGuire Summary of Intended Testimony (no page numbers); Tullio Letter at 9.

<sup>260</sup> Angel Letter at 10.

<sup>261</sup> See Tullio Letter at 9.

<sup>262</sup> NexTrade Letter at 9.

<sup>263</sup> 15 U.S.C. 78s(b). See *supra* note .

not being entered for the purpose of stepping ahead.<sup>271</sup>

At this time, the Commission believes that a basis likely may exist to grant an exemption from the sub-penny quoting prohibition for QQQQ and perhaps other actively traded ETFs. This exemption would permit a national securities exchange, national securities association, ATS, vendor, or broker or dealer to display, rank, or accept from any person a bid or offer, an order, or an indication of interest—in QQQQ or perhaps other actively traded ETFs—in increments smaller than \$0.01. The Commission intends to consider this matter further during the phase-in period for Regulation NMS, if Regulation NMS is adopted. The Commission also notes that, while the proposed effective date for Regulation NMS as a whole would be [November 5, 2005], the effective date for repropoed Rule 612(c), if adopted, would be 60 days from date of publication of final Regulation NMS in the **Federal Register**. Therefore, the Commission could exercise its exemptive authority such that any exemptions that it may grant pursuant to repropoed Rule 612(c) could take effect simultaneously with the main prohibitions of Rule 612.

e. Sub-Penny Trading. The Commission stated in the Proposing Release that it did not at that time believe that *trading* in sub-penny increments raised the same concerns as sub-penny *quoting*. Therefore, the proposed rule would not prohibit an exchange or association from printing a trade in sub-penny increments that was, for example, the result of a mid-point or volume-weighted pricing algorithm, as long as the exchange or association or its members did not otherwise violate the proposed rule with respect to the trading interest that resulted in the execution. For example, a system that accepted unpriced orders that were then matched at the midpoint of the NBBO would not violate the proposed rule even though resulting executions could occur in share prices of less than one cent. In addition, a broker-dealer could, consistent with the proposed rule, provide price improvement to a customer order in an amount that resulted in an execution in an increment less than a penny so long as the broker-dealer did not accept orders that were priced in increments less than a penny. The Commission sought specific comment on this aspect of the proposal.

Every commenter that addressed this issue agreed that any sub-penny rule should permit sub-penny trades that result from midpoint and average-price

algorithms.<sup>272</sup> While most of these commenters believed that the rule should permit broker-dealers to offer sub-penny price improvement to their customers' orders,<sup>273</sup> a few commenters urged the Commission to bar this practice.<sup>274</sup> After considering these views, the Commission has determined not to revise the sub-penny rule in a manner that would prohibit sub-penny trading, whether that trading results from midpoint or VWAP algorithms or from broker-dealers offering sub-penny price improvement. The Commission continues to believe that trading in sub-penny increments does not at this time raise the same concerns as sub-penny quoting.

f. Acceptance of Sub-Penny Quotations. The Commission initially proposed to prohibit national securities exchanges, national securities associations, ATSS, vendors, and broker-dealers from displaying, ranking, or *accepting* quotations in NMS stocks that are priced in sub-pennies. One commenter argued that the rule should allow a market participant to accept sub-penny quotations if it consistently re-prices such quotations to an acceptable increment and does not give the sub-penny quotations any special priority for ranking or execution purposes.<sup>275</sup> A second commenter disagreed, arguing that rounding a sub-penny quotation to the nearest penny may be confusing for investors.<sup>276</sup> The Commission agrees with the second commenter and has determined to revise the proposed rule. The Commission believes that little purpose would be served by permitting market participants to accept sub-penny quotations when such quotations could not be displayed or considered for purposes of ranking. Furthermore, the Commission agrees that permitting market participants to accept sub-penny quotations that must be rounded to comply with the requirements of repropoed Rule 612 could cause confusion among investors.

g. Application to Options Markets. The initially proposed rule, by its terms, would apply only to NMS stocks, but the Commission requested comment on whether the rule should apply to

options.<sup>277</sup> Currently, SRO rules require options to be quoted on the U.S. markets in increments of \$0.05 and \$0.10. Therefore, the problems that could be created by sub-penny quoting currently do not exist in the options markets.

Two commenters believed that the rule should not apply to quoting in options.<sup>278</sup> One of these commenters, assuming that the rule as proposed would allow options with a premium of less than \$1.00 to be quoted in sub-pennies and options with a premium over \$1.00 to be quoted in pennies, argued that this approach "would overwhelm the already taxed capacity of existing options quote processing systems."<sup>279</sup> The Commission believes that it is not necessary or appropriate at this time to apply repropoed Rule 612 to options. If a national securities exchange seeks to quote options in pennies or sub-pennies in the future, it would first need to propose a rule change to that effect under Section 19(b) of the Exchange Act.<sup>280</sup> The Commission would have an opportunity to consider such a proposal at that time, after providing notice and obtaining public comment.<sup>281</sup>

A third commenter, while agreeing strongly with the proposed sub-penny rule, argued that the Commission also should prohibit the Boston Options Exchange ("BOX"), a facility of the Boston Stock Exchange, from using "sub-increment" pricing (*i.e.*, penny prices below the standard \$0.05 and \$0.10 increments used for options) in its "PIP" auction.<sup>282</sup> By initiating a PIP auction, a BOX market participant may execute a portion of its agency order as principal in pennies, and BOX market makers can match that price or offer price improvement to those orders in penny increments during the three-second auction. The Commission previously has approved the BOX trading rules, including the rules governing the PIP, pursuant to Section 19(b) of the Exchange Act.<sup>283</sup> The PIP uses pennies in an auction, not in public quotations. Therefore, the Commission does not believe that the PIP raises the same problems caused sub-penny quotations of non-option securities and, therefore, that it is not

<sup>272</sup> See STANY Letter at 14; STA Letter at 7; SIA Letter at 21; UBS Letter at 10; ACIM Letter at 2; E\*Trade Letter at 11; Amex Letter at 12; Liquidnet Letter at 8.

<sup>273</sup> See ACIM Letter at 2; Amex Letter, Exhibit A, at 31–32; E\*Trade Letter at 11; Liquidnet Letter at 8; BSE Letter at 14; Morgan Stanley Letter at 21; SIA Letter at 21; STA Letter at 7; STANY Letter at 14; UBS Letter at 10.

<sup>274</sup> See CHX Letter at 23; Goldman Sachs Letter at 10; SIA Letter at 21.

<sup>275</sup> See Brut Letter at 26.

<sup>276</sup> See CHX Letter at 23.

<sup>277</sup> See Proposing Release, 69 FR at 11172.

<sup>278</sup> See Amex Letter, Exhibit A, at 32; SIA Letter at 21.

<sup>279</sup> *Id.*

<sup>280</sup> 15 U.S.C. 78s(b).

<sup>281</sup> The Commission has previously stated that, "[g]iven the implications of penny quoting for OPRA, penny quoting would require very careful review by the Commission." Securities Exchange Act Release No. 49068 (Jan. 13, 2004), 69 FR 2775, 2789 (Jan. 20, 2004) ("BOX Approval Order").

<sup>282</sup> See CBOE Letter at 8.

<sup>283</sup> BOX Approval Order, 69 FR at 2789.

<sup>271</sup> See Mercatus Center Letter at 9.

necessary to prohibit the use of pennies in BOX's PIP.

#### D. Exemptive Authority

Reproposed Rule 612(c) would establish procedures for the Commission to exempt from the provisions of Rule 612 any person, security, or quotation, or any class or classes or persons, securities, or quotations, if it determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors. The Commission could grant such exemption either unconditionally or on specified terms and conditions. Reproposed Rule 612(c) also would provide that the Commission may grant an exemption from the sub-penny prohibition by order.

#### V. Market Data Rules and Plan Amendments

The Exchange Act rules and joint-SRO Plans for disseminating market information to the public are the heart of the NMS. Pursuant to these rules and Plans, investors are able to obtain real-time access to the best current quotes and most recent trades for all NMS stocks. As a result, investors of all types—large and small—have access to a comprehensive, accurate, and reliable source of information for the prices of any NMS stock at any time during the trading day.

The SROs generate consolidated market data by participating in the Plans.<sup>284</sup> Pursuant to the Plans, three separate networks disseminate consolidated market information for NMS stocks: (1) Network A for securities listed on the NYSE, (2) Network B for securities listed on the Amex and other national securities exchanges, and (3) Network C for securities traded on Nasdaq. For each security, the data includes (1) an NBBO with prices, sizes, and market center identifications, (2) a montage of the best bids and offers from each SRO that includes prices, sizes, and market center identifications, and (3) a consolidated set of trade reports in the security. The Networks establish fees for this data, which must be filed for Commission approval.<sup>285</sup> In 2003, the Networks collected \$424 million in revenues derived from market data fees and, after deduction of Network expenses, distributed \$386 million to their individual SRO participants.<sup>286</sup>

The overriding objective of the rules and Plan amendments repropoed today would be to preserve the vital benefits that investors currently enjoy, while addressing those particular problems with the current rules and Plans that are most in need of reform. The changes fall into three categories: (1) Modifying the current formulas for allocating market data revenues to the SROs to more appropriately reflect their contributions to public price discovery, (2) establishing non-voting advisory committees to broaden participation in Plan governance, and (3) updating and streamlining the various Exchange Act rules that govern the distribution and display of market information.

#### A. Response to Comments and Basis for Reproposed Rules

##### 1. Alternative Data Dissemination Models

In addition to proposing specific rules and amendments, the Proposing Release discussed and requested comment on the Commission's decision not to propose an alternative model of data dissemination to replace the current consolidation model.<sup>287</sup> The great strength of the current model is that it benefits investors, particularly retail investors, by enabling them to assess prices and evaluate the best execution of their orders by obtaining data from a single source that is highly reliable and comprehensive. But, by requiring vendors and broker-dealers to display data to investors that is consolidated from all markets, the current model effectively also requires the purchase of data from all markets. As a result, the most significant drawback of the current model is that it offers little opportunity for market forces to determine a Network's fees, or the allocation of those fees to a Network's SRO participants. Network fees must be closely scrutinized for fairness and reasonableness, and the revenues resulting from those fees must be allocated to the SROs pursuant to a Plan formula. In addition, individual markets have less freedom to innovate in individually providing their quotation and trade data.

In the Proposing Release, the Commission specifically considered three alternative models that potentially could introduce greater competition and flexibility into the dissemination of market data: (1) A deconsolidation model, (2) a competing consolidators model, and (3) a hybrid model. It decided not to propose any of these alternative models after consideration of

the benefits and drawbacks of each model. The Commission did, however, request comment on whether it should develop an alternative model for disseminating market data to the public, and, in particular, on its evaluation of the strengths and weaknesses of the current model and of the various alternative models for the dissemination of market data.

In response to the Commission's request for comment, a minority of commenters expressed their views regarding the appropriate structure for the dissemination of market information to the public. One group believed that the current model requiring the display of consolidated data in a stock through a Plan processor has produced significant benefits for investors and the markets, although they also strongly recommended that its operation needed to be improved in significant respects.<sup>288</sup> Another group of commenters, in contrast, asserted that the current system has inhibited competition among markets and that the Plans should be eliminated.<sup>289</sup> These commenters further suggested deregulation of market data by allowing markets to sell their own data, and by allowing market forces and competition to control the pricing of such data. They advocated a competing consolidators model or a hybrid model.

a. Competing Consolidators Model. Under a competing consolidators model, the consolidated display requirement would be retained, but the Plans and Networks would no longer be necessary. Each of the nine SROs that participate in the NMS, as well as Nasdaq, would be allowed to establish its own fees, to enter into and administer its own market data contracts, and to provide its own data distribution facility. Any number of data vendors or broker-dealers (*i.e.*, "competing consolidators") could purchase data from the individual SROs, consolidate the data, and distribute it to investors and other data users. Of the commenters that urged the Commission to adopt a competing

<sup>288</sup> See, *e.g.*, Amex Letter, Exhibit A at 11; Angel Letter I at 1; CBOE Letter at 2, 9; CHX Letter at 18–20; Financial Information Forum Letter at 4; Schwab Letter at 11–13; SIA Letter at 26–28; STANY Letter at 14.

<sup>289</sup> See, *e.g.*, Alliance of Floor Brokers Letter at 11; Letter from Daniel M. Clifton, Executive Director, American Shareholders Association, to Jonathan G. Katz, Secretary, Commission, dated June 10, 2004 ("ASA Letter") at 2; ArcaEx Letter at 4, 12, 14; Brut Letter at 22; Financial Services Roundtable Letter at 7; ISE Letter at 8–10; Nasdaq Letter II at 24–26; NYSE Letter, Attachment at 10–11; Letter from Phil Lynch, Chief Executive Officer, Reuters America LLC, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004 ("Reuters Letter") at 2; Specialist Assoc. Letter at 17.

<sup>284</sup> See *infra*, note 21.

<sup>285</sup> See Exchange Act Rule 11Aa3–2(c)(1).

<sup>286</sup> See Proposing Release, 69 FR at 11179 (table setting forth revenues, expenses, and allocations of net income for Networks A, B, and C).

<sup>287</sup> Proposing Release, 69 FR at 11176–11179.

consolidators model,<sup>290</sup> the NYSE, for example, believed that allowing the markets to withdraw from the Plans would “reestablish the link between the value of a market’s data \* \* \* and the fair allocation of costs among \* \* \* users,” thereby ending inter-market subsidies and market-distortive initiatives created by the current system.”<sup>291</sup> Similarly, ArcaEx stated that “the best way to reform the [P]lans is to abolish them altogether and to adopt a competing consolidators model.”<sup>292</sup>

The Commission has considered the comments advocating a competing consolidators model, but continues to question the extent to which the model would in fact subject the level of market data fees to competitive forces. If the benefits of a fully consolidated data stream are to be preserved for investors, every consolidator would need to purchase the data of each SRO to assure that the consolidator’s data stream in fact included the best quotations and most recent trade report in all NMS stocks. Moreover, to comply with the repropoed Trade-Through Rule, each market center would need the quotation data from every other market center in a security. As a practical matter, payment of every SRO’s fees would be mandatory, thereby affording little room for competitive forces to influence the level of fees. Consequently, far from freeing the Commission from involvement in market data fee disputes, the multiple consolidator model would require review of at least ten separate fees for individual SROs and Nasdaq. The overall level of fees would not be reduced unless one or more of the SROs or Nasdaq was willing to accept a significantly lower amount of revenues than they currently are allocated by the Plans. It seems unlikely that any SRO or Nasdaq would voluntarily propose lower fees to reduce their current revenues, and some might well propose higher fees to increase their revenues, particularly those with dominant market shares whose information is most vital to investors. No commenter offered useful, objective standards for the Commission to use in evaluating the separate fees of SROs and Nasdaq. For this and for data quality concerns,<sup>293</sup> the Commission remains unconvinced that discarding the current model in favor of a multiple

consolidator model would benefit investors and the NMS in general.

b. Hybrid Model. Nasdaq advocated a hybrid model of data dissemination as a compromise if the Commission believes that it is necessary to retain the Plans.<sup>294</sup> Under a hybrid approach, basic elements of the current model (including the consolidated display requirement and the Plans) would be retained for quotations representing the NBBO, but all trade reports and all quotations other than the NBBO would be deconsolidated. Because much less consolidated data would be disseminated under this model, the fees for consolidated data would be reduced commensurately. The individual SROs would distribute their own trade and quotation information separately and establish fees for such information. To obtain the data eliminated from the consolidated system, investors would need to pay the separate SRO fees.

In sum, Nasdaq suggested that consolidated data fees should be reduced,<sup>295</sup> but only in the context of advocating a hybrid model that would drastically reduce the quantity of data that would be disseminated to investors (*i.e.*, by eliminating all trade reports and all quotations other than the NBBO). Nasdaq stated that the Commission should allow competitive forces to determine the individual SRO fees for deconsolidated data because trade reports and non-NBBO quotations are not “essential to investors.”<sup>296</sup>

The Commission believes, however, that comprehensive trade and quotation information, even beyond the NBBO, is vital to investors. It remains concerned that an SRO with a significant share of

trading in NMS stocks could exercise market power in setting fees for its data. Few investors could afford to do without the best quotations and trades of such an SRO that is dominant in a significant number of stocks. In the absence of a solid basis to believe that full trade and quotation information would continue to be widely available and affordable to all types of investors under a hybrid model, the Commission has determined that the most responsible course of action is to take such immediate steps are necessary to improve the operation of the current consolidation model.<sup>297</sup>

## 2. Level of Fees and Plan Governance

a. Level of Fees. In the Proposing Release, the Commission emphasized that one of its primary goals with respect to market data is to assure reasonable fees that promote its wide public availability. Comment was requested on the extent to which investors and other data users were relatively satisfied with the products and fees offered by the Networks.<sup>298</sup> At the NMS Hearing, several panelists addressed the current level of fees and questioned whether such fees remained reasonably related to the cost of market data.<sup>299</sup> The Supplemental Release therefore noted the panelists’ views and welcomed comments on the reasonableness of market data fees and whether the Commission should modify its approach to reviewing such fees.<sup>300</sup>

Many commenters recommended that the level of market data fees should be reviewed and that, in particular, greater transparency concerning the costs of market data and the fee-setting process is needed.<sup>301</sup> The Commission agrees. To respond to commenters’ concerns, it has initiated a review of market data fees in its concept release relating to SRO structure.<sup>302</sup> The release discusses and requests comment on a number of issues raised by commenters in the context of SRO revenues and the funding of self-regulation—in particular, whether market data fees are reasonable, whether the Commission should

<sup>294</sup> Nasdaq Letter II at 26–28.

<sup>295</sup> At the NMS Hearing, a representative of Nasdaq stated that the current \$20 fee for professionals to obtain market data in Nasdaq stocks is too high; that the fee, based on a recent analysis of Nasdaq’s cost structure, should be around \$5 to \$7; and that the \$20 fee is a monopoly price “set almost twenty years ago without any active review of how that relates.” Hearing Tr. at 223–224, 253. These remarks subsequently engendered some confusion among the public, which was reflected in many comments on the market data proposals addressing the level of fees. To put these comments in perspective and dispel any potential misconceptions, the following points should be kept in mind: (1) In 1999, the Commission undertook a comprehensive review of market data fees and revenues, which led to a 75% reduction in the fees paid by retail investors for market data; (2) Nasdaq’s suggested \$5 to \$7 monthly fee for professional investors would entitle them to only the NBBO in Nasdaq stocks, which is a fraction of the data that currently is disseminated for the \$20 monthly fee for professional investors for consolidated trades and quotations in Nasdaq stocks; and (3) Nasdaq’s \$5 to \$7 cost estimate encompassed only its own costs and therefore excluded the costs of other SROs that now represent a large percentage of trading in Nasdaq-listed stocks.

<sup>296</sup> Nasdaq Letter II at 27.

<sup>297</sup> The Commission also is concerned about the risk of compromising the quality of market information if the hybrid model were adopted. Proposing Release, 69 FR at 11178.

<sup>298</sup> Proposing Release, 69 FR at 11179.

<sup>299</sup> Hearing Tr. at 223–224, 228–229, 230–231, 233.

<sup>300</sup> Supplemental Release, 69 FR at 30148.

<sup>301</sup> See, e.g., Ameritrade Letter I at 3, 10; ASA Letter at 2; Bloomberg Tradebook Letter at 8–9; Brut Letter at 21–23; Citigroup Letter at 15; Financial Information Forum Letter at 3; Financial Services Roundtable Letter at 6–7; Goldman Sachs Letter at 2, 10; ICI Letter at 21–22; Morgan Stanley Letter at 21–22; Schwab Letter at 2; SIA Letter at 22; STANY Letter at 14; UBS Letter at 10.

<sup>302</sup> SRO Structure Release, *supra* note 30.

<sup>290</sup> See, e.g., ArcaEx Letter at 12, 14; ISE Letter at 8–9; NYSE Letter, Attachment at 10–11.

<sup>291</sup> NYSE Letter at 7 and Attachment at 10. The NYSE provided several reasons for the elimination of the Plans.

<sup>292</sup> ArcaEx Letter at 14.

<sup>293</sup> See Proposing Release, 69 FR at 11178.

reconsider a flexible cost-based approach as described in the 1999 Market Information Release, and whether market data fees should be used to fund SRO operational or regulatory costs. The Commission also has taken steps to promote more transparency with respect to market data fees and the use of market data revenues through its proposal on SRO transparency.<sup>303</sup> The proposal would greatly increase SRO transparency by requiring, among other things, that SROs file public reports with the Commission detailing their sources of revenues and their uses of these revenues. Such reports would enhance the public's ability to evaluate the role of market data revenues in funding SROs. For example, proposed amendments to Form 1, Exhibit I would require exchange SROs to disclose their revenues earned from market information fees, itemized by product, and proposed new Rule 17a-26 would require SROs to file electronic quarterly and annual reports on particular aspects of their regulatory activities.

Some commenters suggested that, instead of modifying the Plan formulas

for allocating market data revenues, the Commission should impose a cost-based limitation on fees.<sup>304</sup> Most, however, adopted a very restricted view of market data costs—solely the costs of the Networks to collect data from the individual SROs and disseminate it to the public.<sup>305</sup> Yet nearly the entire financial burden of collecting and producing market data is borne by the individual markets, not by the Networks. If, for example, an SRO's systems break down on a high-volume trading day and it can no longer provide its data to the Networks, investors would suffer the consequences of a defective data stream, regardless of whether the Networks are able to continue operating.

The commenters' suggested approach to market data fees would eliminate any funding for the SROs that supply data to the Networks, which would have reduced SRO funding by \$386 million in 2003.<sup>306</sup> The Commission is reluctant to impose such a significant and sudden reduction in SRO funding without taking due care for the consequences it might have on the integrity of the U.S. equity markets. When the Commission

last reviewed market data fees and revenues in 1999, it noted the direct connection between an SRO's operational and regulatory functions and the value of its market information:

[T]he value of a market's information is dependent on the quality of the market's operation and regulation. Information is worthless if it is cut off during a systems outage (particularly during a volatile, high-volume trading day when reliable access to market information is most critical), tainted by fraud or manipulation, or simply fails to reflect accurately the buying and selling interest in a security.<sup>307</sup>

Moreover, the U.S. equity markets are not alone in their reliance on market data revenues as a substantial source of funding. All of the other major world equity markets currently derive large amounts of revenues from selling market information, despite having significantly less trading volume and less market capitalization than the NYSE and Nasdaq. To illustrate, the following table sets forth the respective market information revenues, dollar value of trading, and market capitalization for the largest world equity markets in 2003:<sup>308</sup>

	Data revenues (millions)	Trading volume (trillions)	Market capitalization (trillions)
London .....	\$180	\$3.6	\$2.5
NYSE .....	172	9.7	11.3
Nasdaq .....	147	7.1	2.8
Deutsche Bourse .....	146	1.3	1.1
Euronext .....	109	1.9	2.1
Tokyo .....	60	2.1	3.0

In sum, the Commission is committed to assuring that investors are not required to pay unreasonable or unfair fees for the consolidated market information that they must have to participate in the U.S. equity markets. On the other hand, we must maintain high standards of SRO performance, without which the data they produce would be worth little. Some commenters suggested that SRO funding should be provided through more specifically targeted fees, such as an additional regulatory fee to fund market regulation costs. Given the potential harm if vital SRO functions are not adequately funded, we believe that the level of market data fees is most appropriately addressed in a context that looks at SRO funding as a whole. The Commission's review of SRO

structure, governance, and transparency provides a useful context in which these competing policy concerns can be evaluated and balanced appropriately.

The Commission does not believe, however, that reform of the current revenue allocation formulas should be delayed until its review of fees is completed. The distortions caused by these formulas are substantial and ongoing. In particular, it appears that market participants increasingly are engaging in the practice of trade shredding (*i.e.*, splitting large trades into multiple 100-share trades) as a means to increase their share of market data revenues under the current Plan formulas. As discussed below, the re-proposed formula would represent a substantial improvement because it is designed to eliminate trade shredding

and other gaming of the current formulas and because it would more directly allocate revenues to those markets that contribute data to the consolidated data stream that is most useful to investors.

b. Plan Governance. The Commission is re-proposing, substantially as proposed, an amendment to the Plans that would require the creation of non-voting advisory committees ("Governance Amendment"). It provides that the members of an advisory committee have the right to submit their views to the Plan operating committees on Plan matters, including any new or modified product, fee, contract, or pilot program. Most commenters supported the Governance

<sup>303</sup> SRO Transparency Release, *supra* note 31.

<sup>304</sup> See, e.g., Ameritrade Letter I at 10; Goldman Sachs Letter at 10; SIA Letter at 22.

<sup>305</sup> See, e.g., ASA Letter at 2; Citigroup Letter at 16; Schwab Letter at 6; SIA Letter at 25.

<sup>306</sup> See *supra*, note 29.

<sup>307</sup> Market Information Release, 64 FR at 70614-70615.

<sup>308</sup> Data for this table is derived from the 2003 annual reports of the various markets and from

statistics compiled by the World Federation of Exchanges. The exchange rates are as of August 15, 2004.

<sup>309</sup> See, e.g., Amex Letter at 10; Citigroup Letter at 17; Financial Information Forum Letter at 4;

Amendment.<sup>309</sup> They generally believed that expanding the participation of non-SROs parties in Plan governance would be a constructive step. Only a few commenters disagreed, stating that interested parties currently have the ability to communicate their views on Plan matters or questioning the efficacy of the committees.<sup>310</sup>

A number of commenters, however, believed that the proposal did not go far enough to reform the Plans and that even greater participation by interested non-SRO parties in the Plans is needed.<sup>311</sup> Brut suggested that the Commission “consider applying SRO governance standards to [Network processors] going forward, subjecting their operations to the same standards of transparency and accountability” in order to limit their monopoly power.<sup>312</sup> These commenters also raised concerns regarding several other aspects of Plan governance, including current administrative costs and burden, the unanimous vote requirement for Plan action, and the current process for reviewing SRO fee filings and Plan amendments. For instance, the SIA believed that inconsistencies among the Networks regarding administrative requirements and burdens (*i.e.*, agreements and contracts, billing policies, data use policies, and annual audit requirements) contribute to high market data fees and should be reduced, streamlined, and made uniform.<sup>313</sup>

In many respects, the Commission agrees with the concerns expressed by commenters on the administration of the Plans. It believes, however, the Governance Amendment would represent a useful first step toward improving the responsiveness of Plan participants and the efficiency of Plan operations. Expanding the participation of interested parties other than SROs in Plan governance should improve transparency, as well as provide an

established mechanism for alternative views to be heard. Earlier and more broadly based participation could contribute to the ability of the Plans to achieve consensus on disputed issues. Going forward, the Commission is receptive to additional steps that would improve Plan operations in general, particularly those that would streamline fee administration procedures and burdens. Enhanced participation of advisory committee members in Plan affairs potentially should help further this process.

### 3. Revenue Allocation Formula

The proposal included an amendment to the Plans that would modify their formulas for allocating market data revenues to SRO Participants. The current Plan formulas are based solely on the trading activity of an SRO. The proposed formula was intended to address three serious weaknesses in the old formulas: (1) The absence of any allocation of revenues for the quotations contributed by an SRO to the consolidated data stream, (2) an excessive emphasis on the number of trades reported by an SRO that has led to distortive trading practices, such as wash sales, trade shredding, and print facilities, and (3) a disproportional allocation of revenues for a relatively small number of stocks with extremely high trading volume, to the detriment of the thousands of other stocks included in a Network, typically issued by smaller companies, with less trading volume.

To address these problems, the proposed formula included a number of elements, including a Quoting Share, an NBBO Improvement Share, a Trading Share, and a Security Income Allocation. The Quoting Share and NBBO Improvement Share would have provided an allocation of revenues for an SRO's quotations. In particular, the Quoting Share would have allocated revenues for all quotes, both automated and manual, according to the dollar size and length of time that such quotes equaled the price of the NBBO. It included an automatic cutoff of credit for manual quotations, however, when they were left alone at the NBBO. This cut-off was intended to preclude SROs from being allocated revenues merely for slowness in updating their manual quotations. The NBBO Improvement Share would have allocated revenues to SROs for the extent to which they displayed quotations that improved the price of the NBBO.

At the NMS Hearing, representatives of floor-based exchanges stated their intention to adopt hybrid trading models that would primarily display

automated quotations.<sup>314</sup> In response, the Commission, in its Supplemental Release, stated that the prospect of hybrid trading models presented an opportunity for simplifying the proposed allocation formula.<sup>315</sup> It noted that the purpose of the automatic cutoff for manual quotations was to minimize the allocation of revenues for potentially stale quotations and requested comment on whether only automated quotes should be entitled to earn an allocation of revenues. The Supplemental Release also noted that the NBBO Improvement Share was significantly more complex than the other aspects of the proposed formula and that it had been proposed largely to counter the potential for an excessive allocation of revenues for manual quotations. Comment was requested on whether there was any need for the NBBO Improvement Share if manual quotations were excluded from the formula.

The comments generally addressed four broad categories of issues: (1) Whether the current Plan formulas need to be updated, (2) whether quotations should be considered in allocating revenues, (3) whether the size of trades should be considered in allocating revenues, and (4) whether the allocation of revenues should be allocated more evenly across all of a Network's stocks. These comments are discussed below.

a. Need for New Formula. Many commenters agreed with the Commission that, if the Networks were to continue allocating revenues to the SROs, the current allocation formulas needed to be updated.<sup>316</sup> Many of these commenters also believed that the proposed formula should be modified in several respects, and their specific suggestions to improve the proposed formula are discussed below. In general, however, they agreed with the objectives of the proposal to eliminate much of the incentive for distortive trade reporting practices and to begin providing some allocation of revenues for the quotations that SROs contribute to the consolidated data stream.

Other commenters, in contrast, opposed changing the current allocation formulas.<sup>317</sup> Their specific objections to the proposed formula are discussed below, but they also opposed changing the current formulas for more general reasons. First, some believed that, rather

Financial Services Roundtable Letter at 6–7; ICI Letter at 4 and 21 n. 35; Instinet Letter at 7, 46; Nasdaq Letter II at 33; Reuters Letter at 3; STANY Letter at 15.

<sup>310</sup> CBOE Letter at 2, 17; ISE Letter at 2; Specialist Assoc. Letter at 16.

<sup>311</sup> See, e.g., Letter from W. Hardy Callcott, to Jonathan G. Katz, Secretary, Commission, dated May 6, 2004 (“Callcott Letter”) at 4–5 n.10; Citigroup Letter at 17; Financial Services Roundtable Letter at 6–7; Goldman Sachs Letter at 12–13; Instinet Letter at 46; Morgan Stanley Letter at 22; Schwab Letter at 8; SIA Letter at 26; STANY Letter at 15.

<sup>312</sup> Brut Letter at 24.

<sup>313</sup> SIA Letter at 27–28.

<sup>314</sup> Hearing Tr. at 85, 90–92, 94–97, 120–121.

<sup>315</sup> Supplemental Release, 69 FR at 30148.

<sup>316</sup> See, e.g., Amex Letter at 11; ATD Letter at 4; Bloomberg Tradebook Letter at 7; BSE Letter at 15; ICI Letter at 21; Morgan Stanley Letter at 22; Nasdaq Letter II at 31; NYSE Letter, Attachment at 11–12;

<sup>313</sup> SIA Letter at 27–28.

<sup>314</sup> Hearing Tr. at 85, 90–92, 94–97, 120–121.

<sup>315</sup> Supplemental Release, 69 FR at 30148.

<sup>316</sup> See, e.g., Amex Letter at 11; ATD Letter at 4; Bloomberg Tradebook Letter at 7; BSE Letter at 15; ICI Letter at 21; Morgan Stanley Letter at 22; Nasdaq Letter II at 31; NYSE Letter, Attachment at 11–12; STA Letter at 7; UBS Letter 10; Vanguard Letter at 6.



than changing the formulas, the Commission simply should prohibit the particular distortive practices caused by the old formulas and enforce the existing prohibitions against such practices. Commenters also opposed the proposed formula because they believed it incorporated arbitrary judgments about the value of quotations and trades. Finally, those opposed to changing the Plan formulas also believed that the proposed formula was simply too complex to be implemented effectively and that its costs exceeded any benefits that were likely to be gained.

The Commission has considered the views of these commenters, but does not believe that they warrant leaving the current Plan formulas in place. First, the Commission intends to continue to enforce the existing prohibitions against distortive trade reporting practices. Rather than attempting to formulate new prohibitions that address every conceivable harmful practice, however, it has determined to address directly the ultimate source of the problem by reproposing revisions to the current formulas. As long as the allocation of market data revenues is based primarily on reporting a large number of very small trades, the incentive for distortive trading reporting will continue. Moreover, as discussed below, the current formulas are flawed in several important respects beyond the incentives they create for distortive trading reporting practices.

The Commission preliminarily does not believe that the reproposed formula would incorporate arbitrary judgments about the value of trades and quotes. In this regard, it is important to recognize that any formula for allocating market data revenues would reflect some judgment regarding the contribution of the various SROs to the consolidated data stream; otherwise, the revenues could simply be allocated equally among all Plan participants. The Commission's goal in reproposing a new formula is to improve the judgments incorporated in the old Plan formulas to more fully achieve NMS objectives.

For example, the current formula for Network A and Network B treats a 100-share trade the same as a 20,000 share trade in the same stock, even though their importance for price discovery purposes clearly is not equal. All of the current Plan formulas treat a quotation as having no value if it did not result in a trade, even if the quotation was fully accessible and established the NBBO for a substantial period of time, thereby providing price discovery for trades occurring at other markets that internalize orders with reference to the NBBO price. Such formulas based solely

on an SRO's trading activity may have been adequate many years ago when a single market dominated each group of securities, but are seriously outdated now that trading is split among many different markets whose contributions to the public data stream can vary considerably.

The reproposed formula would reflect fairly straightforward determinations about the kinds of data that, in general, are likely to be useful to investors. For example, a \$50,000 quote at the NBBO in a stock is likely more useful to investors than a \$2000 quote in the same stock. Similarly, a \$50,000 trade in a stock is likely more useful to investors in assessing the trading trend of that stock than a \$2000 trade; again, not necessarily in every case, but in general and on average. The reproposed formula would represent a substantial improvement on the old formulas.<sup>318</sup>

The Commission agrees with commenters that the proposed formula was very complex and may have been difficult to implement efficiently. They particularly noted that the proposed NBBO Improvement Share was very difficult to understand and had the potential to be abused through gaming behavior. Given that only automated quotations would be entitled to earn an allocation under the reproposed formula, the proposed NBBO Improvement Share can be deleted, as well as the proposed cutoff of credits for manual quotations left alone at the NBBO. The elimination of these two elements greatly reduces the complexity of the reproposed formula and should promote more efficient implementation of the formula. In addition, the 15% of the Security Income Allocation that was allocated to the NBBO Improvement Share in the proposed formula would now be shifted to the Quoting Share to establish a generally even allocation of revenues between trading and quoting.

The Commission does not agree, however, with those commenters who argued that it would be overly costly

<sup>318</sup> Some commenters were concerned that the proposed formula's use of dollar volume calculations did not sufficiently allocate revenues to markets that trade low-priced stocks. *See, e.g.*, BSE Letter at 18; CHX Letter at 16. The Commission preliminarily believes that dollar volume would be the most appropriate measure, in general, of the importance to investors of trading and quoting information. Per share stock prices, in contrast, are a more arbitrary measure because they are dependent, to a large extent, on the number of shares a company chooses to issue, both originally and through stock splits and reverse stock splits. To the extent the commenters were concerned about the less active stocks of smaller companies, the Security Income Allocation of the reproposed formula would incorporate the square root function precisely to more appropriately allocate revenues to SROs that provide a venue for price discovery in these stocks. *See* section V.A.3.d below.

and complex to calculate the other elements of the proposed formula. An SRO's Trading Share, for example, would not be materially more difficult to calculate than the current Network C formula, which is based on an average of the SRO's proportion of trades and share volume. The Security Income Allocation merely would use the square root function, which is a simple arithmetic calculation. Finally, some commenters believed that the Quoting Share, which would incorporate the total dollar size of the NBBO in a stock throughout the trading year, would result in astronomically high numbers that would be extremely difficult to calculate.<sup>319</sup> In fact, the largest number of Quote Credits in a year for even the highest price stock with the greatest displayed depth at the NBBO would be very unlikely to reach beyond the trillions, a number well within the capabilities of even the most basic spreadsheet program.<sup>320</sup> Moreover, it is the proportion of an SRO's Quote Credits in relation to other SROs that would determine an allocation, not the absolute amount of Quote Credits.

Finally, a few commenters were concerned about the effect of modifying the current allocation formulas on the existing business models and terms of competition for the various markets.<sup>321</sup> The Commission recognizes that reforming formulas that have remained unchanged for many years could affect the competitive position of various markets. Given the severe deficiencies of these formulas, however, it does not believe that the interests of any particular business model should preclude updating the formulas to reflect current market conditions. The reproposed formula is intended to reflect more appropriately the contributions of the various SROs to the consolidated data stream and thereby better align the interests of individual markets with the interests of investors.

b. Quotations that Equal the NBBO. Many commenters supported the proposal to allocate a portion of market

<sup>319</sup> *See, e.g.*, CBOE Letter at 14 (calculation of Quote Credits will "yield astronomical numbers" that "can be expressed only in exponential terms"); NSX Letter at 7 (calculation of large number of Quote Credits is "particularly ludicrous").

<sup>320</sup> For example, assume a stock with an average price of \$100 per share has an unusually large average quoted size of 200,000 shares at both the national best bid and the national best offer throughout every second of the trading year. Over an average 252 trading days during a year, the total Quote Credits in this stock would be 235.9 trillion (\$100\*400,000\*252\*23,400 seconds per trading day). Quote Credits would only be calculated for individual Network stocks and would not be totaled across all Network stocks.

<sup>321</sup> *See, e.g.*, Brut Letter at 22; CHX Letter at 21-22; NSX Letter at 6.

data revenues based on an SRO's quotations, particularly if only automated and accessible quotations would qualify for an allocation.<sup>322</sup> Some commenters, however, were concerned about the risk of harmful gaming behavior by market participants.<sup>323</sup> For example, Instinet stated that the "fundamental problem with the Commission's proposed formula stems from the inherently low cost for market participants to generate quotation information and the consequent high potential for gaming behavior in any formula that attempts to reward such behavior."<sup>324</sup> A specific type of gaming that concerned commenters was "flickering quotes"—quotes that are flashed for a short period of time solely to earn market data revenues, but are not truly accessible and therefore do not add any value to the consolidated quote stream.

The Commission recognizes that abusive quoting behavior is a legitimate concern. It preliminarily does not believe, however, that the repropoed formula would be unacceptably vulnerable to gaming, particularly because only automated and fully accessible quotations would be entitled to earn a share of market data revenues. The potential cost of displaying such quotations, in the form of unprofitable trades, should not be underestimated. Quotations would earn significant revenues only if they represent a significant proportion of the total size of quotations displayed at the NBBO for a stock throughout the trading year. The risk of losses that could result from the execution of orders against large quotations would be likely to dwarf any potential allocation of market data revenues. With the advent of highly sophisticated order-routing algorithms, automated quotations throughout the NMS can be accessed with lightning speed. Some of these algorithms are specifically designed to search the market for displayed liquidity and sweep such liquidity immediately when it is displayed. The market discipline imposed by these order-routing practices should greatly reduce the potential for "low cost" quotations at the NBBO if the repropoed formula were adopted. A market participant would need to think carefully about whether it is truly willing to trade at a price, particularly a price as attractive as the NBBO, before displaying accessible

and automated quotations to earn market data revenues.

A few commenters also opposed the proposed Quoting Share because they believed it represented an attempt by the Commission to control the quoting behavior of market participants.<sup>325</sup> ArcaEx stated for example, that the "most important question is how paying for top-of-book quotes—on a time- and size-weighted basis or on any other basis—encourages beneficial behavior," and questioned whether the Quoting Share would achieve this result. Brut asserted that "[n]ot only would [the proposed formula] increase the potential unnatural trading and quoting behavior, it signifies a desire to use market structure regulation to micro-manage market participant behavior \* \* \*"<sup>326</sup>

These commenters appear to have misunderstood the Commission's objective in proposing to update the current Plan formulas. As noted above, it is unlikely that a marginal increase in market data revenues would significantly alter the quoting behavior of market participants, at least for those not already interested in trading a stock for separate reasons. The potential cost of unprofitable trades would be too high. Rather, the Commission's primary objective would be to correct an existing flaw in the current formulas by allocating revenues to those SROs that, even now, benefit investors by contributing useful quotations to the consolidated data stream. Currently, such SROs do not receive any allocation for providing a venue for this beneficial quoting activity. Basing an allocation on the extent to which an SRO's quotes equal the NBBO would be an appropriate means to correct this flaw, even if it does not always reflect the precise value of quotations.<sup>327</sup>

c. Number and Dollar Volume of Trades. The current Plan formulas allocate revenues based on the number of trades (Networks A and B) or on the average of number of trades and share volume of trades (Network C) reported by SROs. By focusing solely on trading activity (and particularly by rewarding the reporting of many trades no matter

how small their size), these formulas have contributed to a variety of distortive trade reporting practices, including wash sales, shredded trades, and SRO print facilities. To address these practices and to establish a more broad-based measure of an SRO's contribution to the consolidated trade stream, the proposed formula provided that an SRO's Trading Share in a particular stock would be calculated by taking the average of the SRO's percentage of total dollar volume in the stock and the SRO's percentage of qualified trades in the stock. A "qualified trade" was defined as having a dollar volume of \$5000 or more. The Proposing Release requested comment on whether this amount should be higher or lower, or whether trades with a size of less than \$5000 should receive credit that was proportional to their size.<sup>328</sup>

Several commenters believed that small trades contribute to price discovery and should be entitled to earn at least some credit in the calculation of the number of qualified trades.<sup>329</sup> The Commission agrees and has included in the repropoed formula a provision that awards a fractional proportion of a qualified report for trades of less than \$5000. Thus, a \$2500 trade would constitute 1/2 of a qualified report. This approach would greatly reduce the potential for large allocations attributable to shredded trades, while recognizing the contribution of small trades to price discovery.

Two commenters asserted that the \$5000 threshold was arbitrary.<sup>330</sup> As noted in the Proposing Release, an analysis of Network A data indicates that approximately 90% of dollar volume and 50% of trades exceed this threshold. The Commission preliminarily believes that the \$5000 figure represents a reasonable attempt to address the problem of shredding large trades into 100-share trades. By providing only a proportional allocation for trades with dollar amounts below this threshold, the ability of market participants to generate large revenue allocations by shredding trades would be greatly reduced. For example, a 2000-share trade in a \$25 stock could be shredded into twenty trades in the absence of a dollar threshold for qualified trades, but could be shredded into only ten qualified trades under the repropoed formula—a reduction of 50%. Moreover, when combined with the allocation of 50% of revenues to the

<sup>325</sup> ArcaEx Letter at 13; Brut Letter at 22, Phlx Letter at 4.

<sup>326</sup> Brut Letter at 22.

<sup>327</sup> ArcaEx noted that top-of-book quotes make only a partial contribution to price discovery and that depth-of-book quotes are particularly important since decimalization. ArcaEx Letter at 13. The Commission agrees that depth-of-book quotes are important to investors, and for that reason has repropoed amendments to the market data rules to facilitate the independent dissemination of a market's depth of book. The rules would not prevent such a market from charging fees for depth-of-book quotations that are fair and reasonable and not unreasonably discriminatory.

<sup>322</sup> See, e.g., Amex Letter at 11; ATD Letter at 4; Bloomberg Tradebook Letter at 7–8; Morgan Stanley Letter at 22–23; STA Letter at 7; Vanguard Letter at 6.

<sup>323</sup> See, e.g., ArcaEx Letter at 13; Brut Letter at 22; CHX Letter at 19; Instinet Letter at 41.

<sup>324</sup> Instinet Letter at 41.

<sup>328</sup> Proposing Release, 69 FR at 11181.

<sup>329</sup> See, e.g., BSE Letter at 16; CHX Letter at 19–20; E\*Trade Letter at 11.

<sup>330</sup> E\*Trade Letter at 11; Instinet Letter at 42.

Quoting Share and the allocation of another 25% of revenues based on the dollar volume of trades, the \$5000 threshold for qualified trades would eliminate much of the potential reward for trade shredding under repropose formula.

d. Allocation of Revenues Among Network Stocks. The proposed formula included a Security Income Allocation, pursuant to which a Network's total distributable revenues would be allocated among each of the Network's stocks based on the square root of dollar volume. The square root function was intended to adjust for the highly disproportionate level of trading in the very top tier of Network stocks. A few hundred stocks (e.g., the top 5%) are much more heavily traded than the other thousands of Network stocks. The Proposing Release noted that an allocation that simply was directly proportional to trading volume would fail to reflect adequately the importance of price discovery for the vast majority of stocks.<sup>331</sup>

Of the commenters that addressed this issue, four supported the use of a square root function to allocate revenues among stocks.<sup>332</sup> Nasdaq, for example, noted that the "methodology will reduce the disparity between the value of data of the most active and least active securities."<sup>333</sup> Other commenters, in contrast, opposed the use of the square root function to allocate revenues among Network stocks.<sup>334</sup> ArcaEx believed that the proposed allocation method "introduces a steeply progressive tax on liquid stocks to subsidize illiquid stocks" and that the allocation of revenues should remain directly proportional to trading volume.<sup>335</sup>

The Commission has retained the square root function in the repropose formula to allocate distributable Network revenues more appropriately among all of the stocks included in a Network. Although the extent to which Network stocks are tiered according to trading volume varies among the three Networks, it is quite pronounced in each of them. The use of the square root function reflects the Commission's judgment that, on average and not necessarily in every particular case, a \$50,000 trade in a stock with an average daily trading volume of \$500,000 is marginally more useful to investors than

a \$50,000 trade in a stock with an average daily trading volume of \$500 million. Markets that provide price discovery in less active stocks serve an extremely important function for investors in those stocks. Price discovery not only benefits those investors who choose to trade on any particular day, but also benefits those who simply need to monitor the status of their investment. Efficient secondary markets support buy-and-hold investors by offering them a ready opportunity to trade at any time at a fair price if they need to buy or sell a stock. Indeed, this enhanced assurance is one of the most important contributions of secondary markets to efficient capital-formation and to reducing the cost of capital for listed companies. The square root function would allocate revenues to markets that perform this function for less-active stocks by marginally increasing their percentage of market data revenues, while still allocating a much greater dollar amount to more actively traded stocks.

#### 4. Distribution and Display of Data

Most commenters supported the proposal authorizing the independent distribution of market data outside of what is required by the Plans.<sup>336</sup> They generally agreed that the proposal would allow investors and vendors greater freedom to make their own decisions regarding the data they need. They also believed that the Commission's "fair and reasonable" and "not unreasonably discriminatory" standards are appropriate to ensure that the independently distributed market data would be made available to all investors and data users. A few commenters, in contrast, objected to the proposed standards, asserting that the standards would not effectively protect investors and "weaker and newer markets from predatory actions by stronger markets or the potential loss of data integrity."<sup>337</sup>

The Commission is repropose Rule 603(a) as proposed. The "fair and reasonable" and "not unreasonably discriminatory" requirements in repropose Rule 603(a) are derived from the language of Section 11A(c) of the

Exchange Act. Under Section 11A(c)(1)(C), the more stringent "fair and reasonable" requirement is applicable to an "exclusive processor," which is defined in Section 3(a)(2)(B) of the Exchange Act as an SRO or other entity that distributes the market information of an SRO on an exclusive basis. Repropose Rule 603(a)(1) would extend this requirement to non-SRO markets when they act in functionally the same manner as exclusive processors and are the exclusive source of their own data. Applying this requirement to non-SROs would be consistent with Section 11A(c)(1)(F) of the Exchange Act, which grants the Commission rulemaking authority to "assure equal regulation of all markets" for NMS Securities.

Commenters were concerned about the statement in the Proposing Release that the distribution standards would prohibit a market from distributing its data independently on a more timely basis than it makes available the "core data" that is required to be disseminated through a Network processor.<sup>338</sup> Instinet, for example, requested that the Commission clarify that the proposal would not require a market center to artificially slow the independent delivery of its data in order to synchronize its delivery with the data disseminated by the Network.<sup>339</sup> Repropose Rule 603(a) would not require a market center to synchronize the delivery of its data to end-users with delivery of data by a Network processor to end-users. Rather, independently distributed data could not be made available on a more timely basis than core data is made available to a Network processor. Stated another way, repropose Rule 603(a) would require that an SRO or broker-dealer must not transmit data to a vendor or user any sooner than it transmits the data to a Network processor.

A majority of the commenters supported the Commission's proposed reduction of the consolidated display requirements, stating that it should lead to lower costs for investors.<sup>340</sup> A few commenters, however, opposed eliminating the requirement to display a full montage of market BBOs.<sup>341</sup> Amex, for example, believed that elimination of the montage would confuse investors

<sup>331</sup> Proposing Release, 69 FR at 11180.

<sup>332</sup> Amex Letter, Exhibit A at 15; Nasdaq Letter II at 32; NYSE Letter, Attachment at 12; Specialist Assoc. Letter at 16 n.21.

<sup>333</sup> Nasdaq Letter II at 32.

<sup>334</sup> ArcaEx Letter at 12; CBOE Letter at 11; Xanadu Letter at 2-3.

<sup>335</sup> ArcaEx Letter at 12.

<sup>336</sup> See, e.g., Brut Letter at 21, 23; CBOE Letter at 2, 17; Citigroup Letter at 16; Financial Information Forum Letter at 4; Letter from Coleman

Stipanovich, Executive Director, State Board of Administration of Florida, to Jonathan G. Katz, Secretary, Commission, dated June 29, 2004 ("Florida State Board Letter") at 2; Financial Services Roundtable Letter at 6; Goldman Sachs Letter at 12; ICI Letter at 4, 21 n.35; Instinet Letter at 45; Nasdaq Letter II at 33; NYSE Letter, Attachment at 12; Reuters Letter at 3; Schwab Letter at 13.

<sup>337</sup> See, e.g., Amex Letter at 10, Exhibit A at 13.

<sup>338</sup> Amex Letter, Exhibit A at 12.; Instinet Letter at 47; Reuters Letter at 2.

<sup>339</sup> Instinet Letter at 47.

<sup>340</sup> See, e.g., Brut Letter at 21, 23; Financial Information Forum Letter at 3-4; Instinet Letter at 7, 45; Nasdaq Letter II at 27, 32; Reuters Letter at 2-3.

<sup>341</sup> See, e.g., Amex Letter at 9 & Exhibit A at 12; Bloomberg Tradebook Letter at 9; Callcott Letter at 1, 2, 5.

and make it more complicated for vendors and broker-dealers to manage market data.

The Commission does not believe that streamlining the consolidated display requirement would detract from the quality of information made available to investors. Reproposed Rule 603(c) would continue to require the disclosure of basic information (*i.e.*, prices, sizes and market center identifications of the NBBO, along with the most recent last sale information). It would allow market forces, rather than regulatory requirements, to determine what, if any, additional quotations outside the NBBO are displayed to investors. Investors who need the BBOs of each SRO, as well as more comprehensive depth-of-book information, would be able to obtain such data from markets or third party vendors.

### B. Description of Reproposed Rules and Amendments

#### 1. Allocation Amendment

The Commission is reproposing with modifications an amendment to each of the Plans ("Allocation Amendment") that incorporates a broad based measure of the contribution of an SRO's quotes and trades to the consolidated data stream.<sup>342</sup> The reproposed formula reflects a two-step process. First, a Network's distributable revenues (*e.g.*, \$150 million) would be allocated among the many individual securities (*e.g.*, 3000) included in the Network's data stream. Second, the revenues that are allocated to an individual security (*e.g.*, \$200,000) then would be allocated among the SROs based on measures of the usefulness to investors of their trades and quotes in the security. The Allocation Amendment provides that, notwithstanding any other provision of a Plan, its SRO participants would receive an annual payment for each calendar year that is equal to the sum of the SRO's Trading Shares and Quoting Shares in each Network security for the year.<sup>343</sup> These two types of Shares

<sup>342</sup> In 2002, the Commission abrogated several SRO proposals for rebating data revenues to market participants. Securities Exchange Act Release No. 46159 (July 2, 2002), 67 FR 45775 (July 10, 2002). The purpose of the abrogation was to allow more time for the Commission to consider market data issues. Given that the current Plan allocation formulas would be updated to allocate revenues for more beneficial quoting and trading behavior, the Commission anticipates that rebates would be permitted in the future if the reproposed formula were adopted, assuming their terms meet applicable Exchange Act standards and SROs are able to meet their regulatory responsibilities. Such SRO rebates would, of course, have to be filed with the Commission for approval.

<sup>343</sup> Two commenters were concerned that the new formula might prohibit the Network's current

would be dollar amounts that would be calculated based on SRO trading and quoting activity in each Network security.

a. Security Income Allocation. The first step of the reproposed formula would be to allocate a Network's total distributable revenues among the many different securities that are included in a Network (the "Security Income Allocation"). Paragraph (b) of the reproposed Allocation Amendment would base this allocation on the square root of dollar volume of trading in each security. Use of the square root function would more appropriately allocate revenues among stocks with widely differing trading volume. A small number of Network stocks are much more heavily traded than the great majority of Network stocks. By proportionally shifting revenues away from the very top tier of active stocks and increasing the allocation across other stocks, the Security Income Allocation is intended to reflect more adequately the importance of price discovery for all Network stocks.

b. Trading Share. Under paragraph (c) of the reproposed Allocation Amendment, an SRO's Trading Share in a particular Network security would be a dollar amount that is determined by multiplying (i) an amount equal to the lesser of (A) 50% of the Security Income Allocation for the Eligible Security or (B) an amount equal to \$2.00 multiplied by the total number of qualified transaction reports disseminated by the Processor in the Eligible Security during the calendar year, by (2) the SRO's Trade Rating in the security. A Trade Rating would be a number that represents the SRO's proportion of dollar volume and qualified trades in the security, as compared to the dollar volume and qualified trades of all SROs. The Trade Ratings of all SROs would add up to a total of one. Thus, for example, multiplying 50% of the Security Income Allocation for a Network security (*e.g.*, \$200,000) by an SRO's Trade Rating in that security (*e.g.*, 0.2555) would produce a dollar amount (*e.g.*,  $50\% \times \$200,000 \times 0.2555 = \$25,550$ ) that is the SRO's Trading Share for the security for the year.

Applying 50% of the Security Income Allocation to the Trading Share reflects a judgment that generally trades and quotes are of approximately equal

practice of making estimated quarterly payments of Network revenues, with a final reconciliation at the end of the year. BSE Letter at 18, 19; CHX Letter at 22. The reproposed formula, however, merely tracks existing Plan language for the calculation of "Annual Shares" or "annual payments." Nothing in the reproposed formula would prohibit Networks from making estimated quarterly payments.

importance for price discovery purposes. For securities with lower trading volume, however, this percentage can disproportionately allocate revenues for a small number of trades during the year, at the expense of those markets that aggressively quote a security throughout the year. For example, 50% of the Security Income Allocation for a security with 10 qualified trades during the year might be \$300. Rather than allocate the full \$300 to those SROs that reported a small number of trades (for an average per trade allocation of \$30), the reproposed formula would include a cap of \$2 per qualified transaction report, so that a total of only \$20 would be allocated pursuant to the Trading Share. The difference of \$280 (\$300 minus \$20) would be shifted to the Quoting Share to allocate revenues to those markets that consistently displayed valuable quotes in the security throughout the more than 250 trading days during the year. The amount of the cap of \$2 per qualified transaction report exceeds the highest amount per transaction report currently allocated for any of the three Networks.

An SRO's Trade Rating would be calculated by taking the average of (1) the SRO's percentage of total dollar volume reported in the Network security during the year, and (2) the SRO's percentage of total qualified trades reported in the Network security for the year. A transaction report with a dollar volume of \$5000 or more would constitute one qualified report. A transaction report with a dollar volume of less than \$5000 would constitute a proportional fraction of a qualified transaction report. As a result, all sizes of transaction reports would contribute toward an SRO's Trade Rating.

c. Quoting Share. Under paragraph (d) of the reproposed Allocation Amendment, an SRO's Quoting Share in a particular Network Security would be a dollar amount that is determined by multiplying (i) an amount equal to 50% of the Security Income Allocation for the security, plus the difference, if greater than zero, between 50% of the Security Income Allocation for the Eligible Security and an amount equal to \$2.00 multiplied by the total number of qualified transaction reports disseminated by the Processor in the Eligible Security during the calendar year, by (ii) the SRO's Quote Rating in the security. A Quote Rating would be a number that represents the SRO's proportion of quotations that equaled the price of the NBBO during the year ("Quote Credits"), as compared to the Quote Credits of all SRO's during the year. The Quote Ratings of all SROs

would add up to a total of one. Multiplying 50% of the Security Income Allocation for a Network security (plus any shifted allocation from the Trading Share) by an SRO's Quote Rating in that security would produce a dollar amount that is the SRO's Quoting Share for the security for the year.

An SRO would earn one Quote Credit for each second of time and dollar value of size that the SRO's automated quotation during regular trading hours equals the price of the NBBO.<sup>344</sup> Thus, for example, a bid with a dollar value of \$4000 (e.g., a bid of \$20 with a size of 200 shares) that equals the national best bid for three seconds would be entitled to 12,000 Quote Credits. If an SRO quotes simultaneously at both the national best bid and the national best offer, it would earn Quote Credits for each quote. An automated quotation is defined by reference to repropoed Rule 600(b)(3) under Regulation NMS. Thus, an SRO's manual quotations would not be entitled to earn any Quote Credits.

## 2. Governance Amendment

The Governance Amendment is repropoed substantially as proposed. Paragraph (a) would mandate the formation of a Plan advisory committee. Paragraph (b) of the Governance Amendment would set forth the composition and selection process for such an advisory committee. Members of the advisory committee would be selected by the Plan operating committee, by majority vote, for two-year terms. At least one representative would be selected from each of the following five categories: (1) A broker-dealer with a substantial retail investor customer base, (2) a broker-dealer with a substantial institutional investor customer base, (3) an ATS, (4) a data vendor, and (5) an investor. Each Plan participant also would have the right to select one additional member to the advisory committee that is not employed by or affiliated with any Plan participant or its affiliates or facilities.

Paragraphs (c) and (d) of the Governance Amendment would set forth the function of the advisory committee and the requirements for its participation in Plan affairs. Pursuant to paragraph (c), members of an advisory committee would have the right to submit their views to the operating committee on Plan matters, including, but not limited to, any new or modified product, fee, contract, or pilot program that is offered or used pursuant to the

<sup>344</sup> Regular trading hours are defined in repropoed Rule 600(b)(64) of Regulation NMS as between 9:30 a.m. and 4 p.m. eastern time, unless otherwise specified pursuant to the procedures established in repropoed Rule 605(a)(2).

Plan. Paragraph (d) provides that members would have the right to attend all operating committee meetings and to receive any information distributed to the operating committee relating to Plan matters, except when the operating committee, by majority vote, decides to meet in executive session after determining that an item of Plan business requires confidential treatment.

## 3. Consolidation, Distribution, and Display of Data

a. Independent Distribution of Information. The Commission is repropoing, substantially as proposed, the amendment to current Rule 11Aa3-1 (repropoed to be designated as Rule 601), which would rescind the prohibition on SROs and their members from disseminating their trade reports independently.<sup>345</sup> Under repropoed Rule 601, members of an SRO would continue to be required to transmit their trades to the SRO (and SROs would continue to transmit trades to the Networks pursuant to the Plans), but such members also would be free to distribute their own data independently, with or without fees.

Repropoed Rule 603(a) would establish uniform standards for distribution of both quotations and trades that would create an equivalent regulatory regime for all types of markets. First, Rule 603(a)(1) would require that any market information<sup>346</sup> distributed by an exclusive processor, or by a broker or dealer (including ATSS and market makers) that is the exclusive source of the information, be made available to securities information processors on terms that are fair and reasonable. Rule 603(a)(2) would require that any SRO, broker, or dealer that distributes market information must do so on terms that are not unreasonably

<sup>345</sup> Repropoed Regulation NMS would remove the definitions in former paragraph (a) of current Rule 11Aa3-1 and place them in repropoed Rule 600(b). Current subparagraphs (c)(2) and (c)(3) of Rule 11Aa3-1 would be rescinded. As a result, current subparagraph (c)(4) of current Rule 11Aa3-1 would be redesignated as subparagraph (b)(2) of repropoed Rule 601.

<sup>346</sup> The information covered by the amendment tracks the language of Section 11A(c) of the Exchange Act, which applies to "information with respect to quotations for or transactions in" securities. This statutory language encompasses a broad range of information, including information relating to limit orders held by a market center. *See, e.g.,* S. Report No. 94-75, 94th Cong., 1st Sess. 9 (1975) ("In the securities markets, as in most other active markets, it is critical for those who trade to have access to accurate, up-to-the-second information as to the prices at which transactions in particular securities are taking place (i.e., last sale reports) and the prices at which other traders have expressed their willingness to buy or sell (i.e., quotations).").

discriminatory. These requirements would prohibit, for example, a market from making its "core data" (i.e., data that it is required to provide to a Network processor) available to vendors on a more timely basis than it makes available the core data to a Network processor. With respect to non-core data, however, Network processors occupy a unique competitive position. As Network processor, it acts on behalf of all markets in disseminating consolidated information, yet it also may be closely associated with the competitor of a market. The Commission believes that markets should have considerable leeway in determining whether, or on what terms, they provide additional, non-core data to a Network processor.

b. Consolidation of Information. All of the SROs currently participate in Plans that provide for the dissemination of consolidated information for the NMS Stocks that they trade. The Plans were adopted in order to enable the SROs to comply with Exchange Act rules regarding the reporting of trades and distribution of quotations. With respect to trades, paragraph (b) of Exchange Act Rule 11Aa3-1 (proposed to be redesignated as Rule 601(a)) requires each SRO to file transaction reporting plans that specify, among other things, how its transactions are to be consolidated with the transactions of other SROs. With respect to quotations, paragraph (b)(1) of Exchange Act Rule 11Ac1-1 (proposed to be redesignated as Rule 602(a)(1)) requires an SRO to establish and maintain procedures for making its best quotes available to vendors.

To confirm by Exchange Act rule that both existing and any new SROs would be required to continue to participate in such joint-SRO plans, repropoed Rule 603(b) would require SROs to act jointly pursuant to one or more NMS plans to disseminate consolidated information for NMS Stocks. Such consolidated information would be required to include an NBBO that is calculated in accordance with the definition set forth in repropoed Rule 600(b)(42).<sup>347</sup> In addition, the NMS plans would be required to provide for the dissemination of all consolidated information for an individual NMS stock through a single processor. Thus, different processors would be permitted to disseminate information for different NMS stocks (e.g., SIAC for Network A stocks, and Nasdaq for Network C stocks), but all quotations and trades in

<sup>347</sup> Repropoed Rule 600(b)(42) of Regulation NMS defines "national best bid and national best offer."

a stock would be disseminated through a single processor. As a result, information users, particularly retail investors, could obtain data from a single source that reflects the best quotations and most recent trade price for a security, no matter where such quotations and trade are displayed in the NMS.

c. **Display of Consolidated Information.** Reproposed Rule 603(c) (currently Exchange Act Rule 11Ac1-2) substantially revises the consolidated display requirement. It would incorporate a new definition of “consolidated display” (set forth in reproposed Rule 600(b)(13)) that would be limited to the prices, sizes, and market center identifications of the NBBO, along with the “consolidated last sale information” (which is defined in Rule 600(b)(12)). Beyond disclosure of this basic information, market forces, rather than regulatory requirements, would be allowed to determine what, if any, additional data from other market centers is displayed. In particular, investors and other information users ultimately would be able to decide whether they need additional information in their displays.

In addition, reproposed Rule 603(c) would narrow the contexts in which a consolidated display is required to those when it is most needed—a context in which a trading or order-routing decision could be implemented. For example, the consolidated display requirement would continue to cover broker-dealers who provide on-line data to their customers in software programs from which trading decisions can be implemented. Similarly, the requirement would continue to apply to vendors who provide displays that facilitate order routing by broker-dealers. It would not apply, however, when market data is provided on a purely informational website that does not offer any trading or order-routing capability.<sup>348</sup>

## VI. Regulation NMS

To simplify the structure of the rules adopted under Section 11A of the Exchange Act (“NMS rules”), the rules reproposed today would designate the NMS rules as Regulation NMS, renumber the NMS rules, and would establish a new definitional rule, reproposed Rule 600 (“NMS Security

Designation and Definitions”). Rule 600(a) would replace Exchange Act Rule 11Aa2-1, which designates “reported securities” as NMS securities. In addition, Rule 600(b) would include, in alphabetical order, all of the defined terms used in Regulation NMS. Regulation NMS would include reproposed Rules 610, 611, and 612 in addition to the existing NMS rules. The new rule series would be Rule 600 through Rule 612 (17 CFR 242.600–612).

Reproposed Rule 600 would provide a single set of definitions that would be used throughout Regulation NMS. To create a single set of definitions, Rule 600 would update or delete from the existing NMS rules some terms that have become obsolete and eliminate the use of multiple inconsistent definitions for identical terms. In addition, Rule 600 repropose new terms, “NMS security” and “NMS stock,” to replace some terms that have been eliminated. These terms would be necessary to maintain distinctions between NMS rules that apply only to equity securities and ETFs (e.g., Exchange Act Rules 11Ac1-4 and 11Ac1-5, proposed to be redesignated as Rules 604 and 605) and those that apply to equity securities, ETFs, and options (e.g., Exchange Act Rules 11Ac1-1 and 11Ac1-6, proposed to be redesignated as Rules 602 and 606). Rule 600 would retain, unchanged, most definitions used in the existing NMS rules and would include definitions used in the new NMS rules reproposed today. The definitional changes would not affect the substantive requirements of the existing NMS rules. In addition, the reproposal would amend a number of other Commission rules that cross-reference current NMS rules or that use terms that Regulation NMS would amend or eliminate.

The Commission received no comments regarding proposed Rule 600, the proposed redesignation of the NMS rules as Regulation NMS, or the proposed changes to other Commission rules. Accordingly, the Commission is reproposing Rule 600 and redesignating the NMS rules as Regulation NMS, and reproposing technical amendments to certain other Commission rules that cross-reference current NMS rules or that use terms that Regulation NMS would amend or eliminate, substantially as proposed.<sup>349</sup>

### A. Description of Regulation NMS

Reproposed Regulation NMS would renumber and, in some cases, rename the existing NMS rules, and would

incorporate Rule 600 and the other NMS rules reproposed today. Where applicable, existing NMS rules would be amended to remove the definitions that have been consolidated in Rule 600. The titles and numbering of the rules in Regulation NMS, including the NMS rules reproposed today, would be as follows:

- **Rule 600:** NMS Security Designation and Definitions (would replace Exchange Act Rule 11Aa2-1, which the Commission is proposing to rescind, and incorporate definitions from the existing NMS rules and the reproposed new rules);
- **Rule 601:** Dissemination of Transaction Reports and Last Sale Data with Respect to Transactions in NMS Stocks (would renumber and rename current Exchange Act Rule 11Aa3-1, the substance of which would be modified);<sup>350</sup>
- **Rule 602:** Dissemination of Quotations in NMS Securities (would renumber and rename current Exchange Act Rule 11Ac1-1 (“Quote Rule”), the substance of which would remain largely intact);
- **Rule 603:** Distribution, Consolidation, and Display of Information with Respect to Quotations for and Transactions in NMS Stocks (would renumber and rename current Exchange Act Rule 11Ac1-2 (“Vendor Display Rule”), the substance of which would be modified substantially);<sup>351</sup>
- **Rule 604:** Display of Customer Limit Orders (would renumber current Exchange Act Rule 11Ac1-4 (“Limit Order Display Rule”), the substance of which would remain largely intact);
- **Rule 605:** Disclosure of Order Execution Information (would renumber current Exchange Act Rule 11Ac1-5, the substance of which would remain largely intact);
- **Rule 606:** Disclosure of Order Routing Information (would renumber current Exchange Act Rule 11Ac1-6, the substance of which would remain largely intact);
- **Rule 607:** Customer Account Statements (would renumber current Exchange Act Rule 11Ac1-3, the substance of which would remain largely intact);
- **Rule 608:** Filing and Amendment of National Market System Plans (would renumber current Exchange Act Rule 11Aa3-2, the substance of which would remain largely intact);

<sup>350</sup> In the market data rules, discussed in Section V., the Commission is reproposing substantive amendments to Exchange Act Rule 11Aa3-1 (proposed to be redesignated as Rule 601).

<sup>351</sup> In the market data rules, discussed in Section V., the Commission repropose substantive amendments to the Vendor Display Rule.

<sup>348</sup> The amendment would retain the exemptions currently set forth in Rule 11Ac1-2(f) (proposed to be redesignated as Rule 603(c)(2)) for exchange and market linkage displays. The current exemption for displays used by SROs for monitoring or surveillance purposes would no longer be necessary because of the limitation of the amendment to trading and order-routing contexts.

<sup>349</sup> See *infra* note 394 for a list of rules to which technical amendments are proposed that are in addition to those originally proposed.

- Rule 609: Registration of Securities Information Processors: Form of Application and Amendments (would renumber current Exchange Act Rule 11Ab2-1, the substance of which would remain largely intact);

- Rule 610: Access to Quotations (reproposed in this release);

- Rule 611: Order Protection Rule (reproposed in this release); and

- Rule 612: Minimum Pricing Increment (reproposed in this release).

## B. Rule 600—NMS Security Designation and Definitions

### 1. NMS Security Designation—Transaction Reporting Requirements for Equities and Listed Options

Section 11A(a)(2) of the Exchange Act directs the Commission to “designate the securities or classes of securities qualified for trading in the national market system.”<sup>352</sup> The 1975 Amendments and the legislative history to the 1975 Amendments were silent as to the particular standards the Commission should employ in designating NMS securities.<sup>353</sup> Instead, Congress provided the Commission with the flexibility and discretion to base NMS designation standards on the Commission’s experience in facilitating the development of an NMS.<sup>354</sup>

To satisfy the requirement that it designate the securities qualified for trading in the NMS, the Commission adopted Exchange Act Rule 11Aa2-1 in 1981.<sup>355</sup> Exchange Act Rule 11Aa2-1 defines the term “national market system security” to mean “any reported security as defined in Rule 11Aa3-1.” A “reported security” is “any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan.”<sup>356</sup> An “effective transaction reporting plan” is “any transaction reporting plan approved by the Commission pursuant to this section.”<sup>357</sup> A “transaction reporting plan” is “any plan for collecting, processing, making available or disseminating transaction reports with respect to transactions in reported securities filed with the Commission pursuant to, and meeting the requirements of, this section.”<sup>358</sup> The

effective transaction reporting plans are the CTA Plan and the Nasdaq UTP Plan.

In addition to identifying those securities deemed to be NMS securities, when adopted, the Exchange Act Rule 11Aa2-1 designation also tacitly identified those securities that did not meet that designation (*i.e.*, securities other than those that were so designated as NMS securities). Historically, securities excluded from this designation included standardized options and small capitalization equity securities (a subset of which has been identified as Nasdaq SmallCap securities). Trading in options and Nasdaq SmallCap securities has increased over the past three decades and gradually many of the rules that govern NMS securities have been applied to these securities. As a result, much of the terminology that has been used to distinguish NMS securities from options and Nasdaq SmallCap securities has become obsolete.

For example, the Nasdaq UTP Plan provides for the collection from Plan participants, and the consolidation and dissemination to vendors, subscribers and others, of quotation and transaction information in “eligible securities.” Prior to 2001, the Nasdaq UTP Plan defined an “eligible security” as any Nasdaq National Market security as to which unlisted trading privileges have been granted to a national securities exchange pursuant to Section 12(f) of the Exchange Act or that is listed on a national securities exchange. In 2001, the Nasdaq UTP Plan was amended to include Nasdaq SmallCap securities.<sup>359</sup> As a result, Nasdaq SmallCap securities became “eligible securities” because they are now reported through an effective transaction reporting plan (*i.e.*, the Nasdaq UTP Plan), bringing them within the purview of the NMS security designation. Several definitions in the existing NMS rules, however, do not reflect the inclusion of Nasdaq SmallCap securities in the Nasdaq UTP

<sup>359</sup> See NASD Rule 4200 for the definition of a Nasdaq SmallCap security. The Nasdaq UTP Plan provides for the collection from Plan participants, and the consolidation and dissemination to vendors, subscribers and others, of quotation and transaction information in “eligible securities.” “Eligible securities” initially included Nasdaq NMS securities listed on an exchange or traded on an exchange pursuant to a grant of unlisted trading privileges. See Securities Exchange Act Release No. 28146 (June 26, 1990), 55 FR 27917 (July 6, 1990) (order approving the Nasdaq UTP Plan on a pilot basis). In 2001, the Nasdaq UTP Plan was amended to, among other things, revise the definition of “eligible securities” to include Nasdaq SmallCap securities. See Securities Exchange Act Release No. 45081 (Nov. 19, 2001), 66 FR 59273 (Nov. 27, 2001) (order approving Amendment No. 12 to the Nasdaq UTP Plan).

Plan and therefore must be updated. Regulation NMS would do so.

In addition, transactions in exchange-listed options are reported through the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information (“OPRA Plan”).<sup>360</sup> Unlike the CTA Plan and the Nasdaq UTP Plan—transaction reporting plans that the Commission approved pursuant to Exchange Act Rules 11Aa3-1 and 11Aa3-2 (proposed to be redesignated as Rules 601 and 608)—the Commission approved the OPRA Plan pursuant to Exchange Act Rule 11Aa3-2 (proposed to be redesignated as Rule 608).<sup>361</sup> As such, the OPRA Plan is an “effective national market system plan” but not an “effective transaction reporting plan.” While at their core the CTA Plan, the Nasdaq UTP Plan, and the OPRA Plan perform essentially the same function (*i.e.*, they govern the consolidated reporting of securities transactions by Plan participants), because the OPRA Plan is not an effective transaction reporting plan, listed options covered by the OPRA Plan are technically not “securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan.” Therefore, listed options were not considered NMS securities as defined by Exchange Act Rule 11Aa2-1. While the impact of this distinction may not be readily apparent, the differences in the way the Plans are designated dictates the securities laws and regulations that apply to securities reported pursuant to those Plans.

Further, as discussed below, some terms in the existing NMS rules have become superfluous or outdated, and some NMS rules define identical terms differently. To provide a consolidated set of definitions applicable to all of the NMS rules, Regulation NMS would eliminate these inconsistencies. The definitional changes reproposed today, however, are not intended to change materially the scope of the existing NMS rules.

### 2. NMS Security and NMS Stock

Some NMS rules, including the Quote Rule (proposed to be redesignated as Rule 602) and Exchange Act Rule 11Ac1-6 (proposed to be redesignated as Rule 606), currently apply to both (1)

<sup>360</sup> The exchanges that are participants to the OPRA Plan are Amex, BSE, CBOE, ISE, PCX, and Phlx.

<sup>361</sup> See Securities Exchange Act Release No. 17638 (Mar. 18, 1981), 22 S.E.C. Docket 484 (Mar. 31, 1981). Exchange Act Rule 11Aa3-2 (proposed to be redesignated as Rule 608) codifies the procedures that SROs must follow to seek approval for or amendment of a national market system plan.

<sup>352</sup> 15 U.S.C. 78k-1(a)(2).

<sup>353</sup> See Securities Exchange Act Release No. 23817 (Nov. 17, 1986), 51 FR 42856 (Nov. 26, 1986) (proposing amendments to Exchange Act Rules 11Aa2-1 and 11Aa3-1).

<sup>354</sup> See *id.*

<sup>355</sup> See Securities Exchange Act Release No. 17549 (Feb. 17, 1981), 46 FR 13992 (Feb. 25, 1981) (adopting Exchange Act Rule 11Aa2-1).

<sup>356</sup> See Exchange Act Rule 11Aa3-1(a)(4).

<sup>357</sup> See Exchange Act Rule 11Aa3-1(a)(3).

<sup>358</sup> See Exchange Act Rule 11Aa3-1(a)(2).

equities, ETFs and related securities for which transaction reports are made available pursuant to an effective transaction reporting plan, and (2) listed options for which market information is made available pursuant to an effective national market system plan. To provide a single term that will be used in any provision of Regulation NMS that applies to both categories of securities, Regulation NMS repropose a new term, "NMS security."<sup>362</sup>

Because many rules in Regulation NMS, including the Limit Order Display Rule (proposed to be redesignated as Rule 604) and Exchange Act Rule 11Ac1-5 (proposed to be redesignated as Rule 605), continue to be inapplicable to listed options, Regulation NMS repropose a new term, "NMS stock" that would be used in those provisions. Regulation NMS would define the term "NMS stock" as "any NMS security other than an option."<sup>363</sup>

### 3. Changes to Existing Definitions in the NMS Rules

Reproposed Rule 600(b) would provide a single set of definitions that would be used throughout Regulation NMS. To create a single set of definitions, Regulation NMS would eliminate multiple, inconsistent definitions of identical terms. In addition, Regulation NMS would amend some definitions in the NMS rules to reflect changed conditions in the marketplace or to modernize references. For example, as discussed above, several definitions in the existing NMS rules have been rendered obsolete by the extension of the Nasdaq UTP Plan to Nasdaq SmallCap securities.<sup>364</sup> Because the Nasdaq UTP Plan includes Nasdaq SmallCap securities, those securities now are "securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan" (*i.e.*, they are "reported" securities).<sup>365</sup> For this reason, it is no

longer necessary to distinguish, as several existing NMS rules do, between "reported" securities and equity securities for which market information is made available through Nasdaq.<sup>366</sup> Accordingly, Regulation NMS would eliminate or revise the defined terms in the existing NMS rules that make this distinction.

a. Covered Security. Different definitions of the term "covered security" appeared in the Quote Rule, the Limit Order Display Rule, and Exchange Act Rule 11Ac1-6.<sup>367</sup> In addition, as discussed below, the term has become obsolete. Therefore, Regulation NMS would eliminate the term "covered security" from the NMS rules and replaces it with the term "NMS security" or "NMS stock," as applicable, depending upon the scope of the particular rule.

b. Reported Security. Several NMS rules used the term "reported security."

and made available pursuant to an effective transaction reporting plan." See Exchange Act Rules 11Ac1-2(a)(20) and 11Aa3-1(a)(4). As discussed more fully below, the Quote Rule provides a different definition of "reported security."

<sup>366</sup> See *e.g.*, paragraph (a)(4) of the Vendor Display Rule (defining "subject security" to mean "(i) any reported security; and (ii) any other equity security as to which transaction reports, last sale data or quotation information is disseminated through NASDAQ"); and paragraph (a)(6) of the Quote Rule (defining "covered security" to mean "any reported security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii))").

<sup>367</sup> Although the Quote Rule and the Limit Order Display Rule each define the term "covered security" as "any reported security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii)), the scope of the definitions is not identical because each rule defines the term "reported security" differently. The Quote Rule defines a "reported security" to mean "any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." See Exchange Act Rule 11Ac1-1(a)(20). The Limit Order Display Rule defines a "reported security" to mean "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan." See Exchange Act Rule 11Ac1-4(a)(10).

Exchange Act Rule 11Ac1-6 defines the term "covered security" to mean: "(i) any national market system security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as defined in Section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii)); and (ii) any option contract traded on a national securities exchange for which last sale reports and quotation information are made available pursuant to an effective national market system plan." See Exchange Act Rule 11Ac1-6(a)(1).

Although the Limit Order Display Rule, the Vendor Display Rule, and Exchange Act Rule 11Aa3-1 contain identical definitions of "reported security," the Quote Rule provides a different definition.<sup>368</sup> Because the term "reported security" is defined inconsistently in the NMS rules and in light of the repropose changes to related terms, Regulation NMS would eliminate the term "reported security" from the NMS rules and replace it with the term "NMS security" or "NMS stock," depending on the scope of the particular rule.

The Limit Order Display Rule uses the term "reported security" solely for the purpose of defining the term "covered security."<sup>369</sup> Because Regulation NMS would eliminate the term "covered security," the term "reported security" also would not be needed in the Limit Order Display Rule (proposed to be redesignated as Rule 604). Therefore, the term "NMS stock" would replace the term "covered security" in the Limit Order Display Rule.

Similarly, the Quote Rule uses the term "reported security" primarily to define the term "covered security."<sup>370</sup> Because Regulation NMS would eliminate the term "covered security," the Quote Rule (proposed to be redesignated as Rule 602)<sup>371</sup> also would not use the term "reported security."

c. Subject Security. The Quote Rule and the Vendor Display Rule both use the term "subject security," although they define the term differently. To

<sup>368</sup> The Limit Order Display Rule, the Vendor Display Rule, and Exchange Act Rule 11Aa3-1 define a "reported security" to mean "any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan." See Exchange Act Rules 11Ac1-4(a)(10), 11Ac1-2(a)(20), and 11Aa3-1(a)(4). The Quote Rule defines the term "reported security" to mean "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." See Exchange Act Rule 11Ac1-1(a)(20). As discussed above, this release repropose substantial modifications to the Vendor Display Rule.

<sup>369</sup> The Limit Order Display Rule defines a "covered security" to include both reported securities and other securities for which market information is disseminated through Nasdaq. See Exchange Act Rule 11Ac1-4(a)(5).

<sup>370</sup> The Quote Rule defines a "covered security" to include both reported securities and other securities for which market information is disseminated through Nasdaq. See Exchange Act Rule 11Aa1-1(a)(6).

<sup>371</sup> In paragraph (b)(1)(ii) of the Quote Rule (proposed to be redesignated as Rule 602), which requires a registered national securities association to disseminate quotations at all times when last sale information is available with respect to "reported securities," the reference to "reported security" would be replaced by a reference to "NMS security."

<sup>362</sup> Specifically, repropose Regulation NMS would define an "NMS security" as "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." This definition is used to define a "reported security" in the Quote Rule. See Exchange Act Rule 11Ac1-1(a)(20). For the reasons described below, the Commission would eliminate the term "reported security" from the Quote Rule and would not include it in Regulation NMS.

<sup>363</sup> Repropose Rule 600(b)(47).

<sup>364</sup> See *supra* Section VI.B.1.

<sup>365</sup> The Vendor Display Rule and Exchange Act Rule 11Aa3-1 define the term "reported security" to mean "any security or class of securities for which transaction reports are collected, processed



eliminate this inconsistency, the repropoed Vendor Display Rule (proposed to be redesignated as Rule 603) would not use the term "subject security" and Regulation NMS would retain a slightly modified version of the definition of "subject security" currently found in the Quote Rule.

The Vendor Display Rule defines the term "subject security" to mean "(i) any reported security; and (ii) any other equity security as to which transaction reports, last sale data or quotation information is disseminated through NASDAQ."<sup>372</sup> As discussed above, the extension of the Nasdaq UTP Plan to include Nasdaq SmallCap securities renders obsolete the distinction between a "reported security" and a security for which market information is disseminated through Nasdaq. Accordingly, the repropoed Vendor Display Rule (proposed to be redesignated as Rule 603) would use the term "NMS stock" rather than "subject security."

The Quote Rule defines the term "subject security" to mean:

(i) With respect to an exchange: (A) Any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system; and (B) Any other covered security for which such exchange has in effect an election, pursuant to paragraph (b)(5)(i) of this section, to collect, process, and make available to quotation vendors bids, offers, quotation sizes, and aggregate quotation sizes communicated on such exchange; and

(ii) With respect to a member of an association: (A) Any exchange-traded security for which such member acts in the capacity of an OTC market maker unless the executed volume of such member, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system; and (B) Any other covered security for which such member acts in the capacity of an OTC market maker and has in effect an election, pursuant to paragraph (b)(5)(ii) of this section, to communicate to its association bids, offers and quotation sizes for the purpose of making such bids, offers and quotation sizes available to quotation vendors.<sup>373</sup>

Because the Quote Rule (proposed to be redesignated as Rule 602) would

continue to apply to both listed options and equities covered by an effective transaction reporting plan, Regulation NMS's definition of "subject security" would revise the Quote Rule's definition of "subject security" by replacing references to a "covered security" with references to an "NMS security." In addition, for the reasons discussed below, Regulation NMS would replace the phrase "reported in the consolidated system" with the phrase "reported pursuant to an effective transaction reporting plan or effective national market system plan."

d. Consolidated System. As noted above, the definition of the term "subject security" in the Quote Rule uses the phrase "reported in the consolidated system."<sup>374</sup> Paragraph (a)(5) of the Quote Rule defines the term "consolidated system" to mean "the consolidated transaction reporting system, including a transaction reporting system operating pursuant to an effective national market system plan."<sup>375</sup>

Regulation NMS would clarify the definition of "subject security" by eliminating the phrase "reported in the consolidated system" and replacing it with the phrase "reported pursuant to an effective transaction reporting plan or an effective national market system plan." Thus, Regulation NMS would define a "subject security" to include, among other things: (1) With respect to a national securities exchange, any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported pursuant to an effective transaction reporting plan or effective national market system plan; and (2) with respect to a member of a national securities association, any exchange-traded security for which such member acts in the capacity of an OTC market maker unless the executed volume of such member, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported pursuant to an effective transaction reporting plan or effective national market system plan.<sup>376</sup>

This change would provide a clearer definition of "subject security" by indicating that the trading volume referred to in the definition is the trading volume in a security that is reported pursuant to an effective

transaction reporting plan or an effective national market system plan. Although replacing the phrase "reported in the consolidated system" with the phrase "reported pursuant to an effective transaction reporting plan or an effective national market system plan" produces a clearer definition of "subject security," it would not alter the scope or the substance of the definition.<sup>377</sup>

e. National Securities Exchange. Section 3(a)(1) of the Exchange Act defines the term "exchange" to mean "any organization, association, or group of persons \* \* \* which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood." \* \* \*<sup>378</sup> Exchange Act Rule 3b-16,<sup>379</sup> adopted in 1998, interprets the statutory definition of "exchange" broadly to include any organization, association, or group of persons that: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade. Exchange Act Rule 3b-16 was designed to provide "a more comprehensive and meaningful interpretation of what an exchange is in light of today's markets."<sup>380</sup>

The Quote Rule's definition of an "exchange market maker" defines the term "national securities exchange" as an "exchange."<sup>381</sup> To avoid confusion between a "national securities exchange" and the broader interpretation of "exchange" set forth in Exchange Act Rule 3b-16, Regulation NMS would use the term "national

<sup>377</sup> This change also would impact certain non-NMS rules that define the term "consolidated system." See, e.g., Exchange Act Rule 10b-18(a)(7) ("consolidated system means the consolidated transaction reporting system contemplated by Rule 11Aa3-1"). As discussed below, the Commission is also repropoing to amend certain non-NMS rules that are affected by the definitional changes repropoed today.

<sup>378</sup> 15 U.S.C. 78c(a)(1).

<sup>379</sup> 17 CFR 240.3b-16.

<sup>380</sup> See Securities Exchange Act Release No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998) (adopting Regulation ATS).

<sup>381</sup> Specifically, the Quote Rule states that the term "exchange market maker" shall mean "any member of a national securities exchange ('exchange') who is registered as a specialist or market maker pursuant to the rules of such exchange." See Exchange Act Rule 11Ac1-1(a)(9). The statutory requirements applicable to a national securities exchange are set forth in Section 6 of the Exchange Act, 15 U.S.C. 78f.

<sup>372</sup> See Exchange Act Rule 11Ac1-2(a)(4).

<sup>373</sup> See Exchange Act Rule 11Ac1-1(a)(25) (emphasis added).

<sup>374</sup> *Id.*

<sup>375</sup> See Exchange Act Rule 11Ac1-1(a)(5).

<sup>376</sup> Repropoed Rule 600(b)(73).

securities exchange” rather than “exchange” throughout the Regulation. The national securities exchange definition is intended to capture only those entities that operate as national securities exchanges and that are registered as such with the Commission. It is not intended to capture those entities that meet the “exchange” definition under Regulation ATS but that operate as something other than a national securities exchange. The use of this term would be consistent with the use of the term “exchange” in the existing NMS rules.

f. OTC Market Maker. The Quote Rule and Exchange Act Rule 11Ac1-5 define the term “OTC market maker” differently.<sup>382</sup> Unlike the Quote Rule, Exchange Act Rule 11Ac1-5 defines the term “OTC market maker” to include an explicit reference to a securities dealer that holds itself out as being willing to buy from and sell to customers or others in the United States. Regulation NMS would retain the reference to transactions with “customers or others in the United States” to indicate clearly that a foreign dealer could be an “OTC market maker” if it acts as a securities dealer with respect to customers or others in the United States.

Accordingly, Regulation NMS would define “OTC market maker” as “any dealer that holds itself out as being willing to buy from and sell to its customers, or others, in the United States, an NMS stock for its own account on a regular or continuous basis otherwise than on a national securities exchange.”<sup>383</sup>

g. Vendor. The term “vendor” or “quotation vendor” is defined differently in three NMS rules: the Quote Rule, the Vendor Display Rule, and Exchange Act Rules 11Aa3-1.<sup>384</sup>

<sup>382</sup> Compare Exchange Act Rules 11Ac1-1(a)(13) and 11Ac1-5(a)(18).

<sup>383</sup> The repropoed definition of “OTC market maker” uses the term “NMS stock” because there is no OTC market in standardized options.

<sup>384</sup> The Quote Rule define the term “quotation vendor” to mean “any securities information processor engaged in the business of disseminating to brokers, dealers or investors on a real-time basis, bids and offers made available pursuant to this section, whether distributed through an electronic communications network or displayed on a terminal or other display device.” See Exchange Act Rule 11Ac1-1(a)(19). Exchange Act Rule 11Aa3-1(a)(11) defines the term “vendor” to mean “any securities information processor engaged in the business of disseminating transaction reports or last sale data with respect to transactions in reported securities to brokers, dealers or investors on a real-time or other current and continuing basis, whether through an electronic communications network, moving ticker or interrogation device.” The Vendor Display Rule defines the term “vendor” to mean “any securities information processor engaged in the business of disseminating transaction reports, last sale data or quotation information with respect to subject securities to brokers, dealers or investors

Although the definitions are similar, the definition of “vendor” in the Vendor Display Rule is the most comprehensive because it encompasses any SIP that disseminates transaction reports, last sale data, or quotation information, whereas the other definitions are less complete in identifying the types of information that vendors typically make available. To provide a uniform and comprehensive definition of the term “vendor,” Regulation NMS repropoed to include the definition of “vendor” as it was defined in the Vendor Display Rule.<sup>385</sup>

h. Best Bid, Best Offer, and National Best Bid and National Best Offer. The Quote Rule and the Vendor Display Rule define the terms “best bid” and “best offer” differently.<sup>386</sup> In addition, Exchange Act Rule 11Ac1-5(a)(7) defines the term “consolidated best bid and offer” to mean “the highest firm bid and the lowest firm offer for a security that is calculated and disseminated on a current and continuous basis pursuant to an effective national market system plan.” Regulation NMS would retain the definitions of “best bid” and “best offer” used in the Quote Rule. A new term called “national best bid and national best offer”: (1) Would replace the term “best bid and best offer” as that term is used in the Vendor Display Rule; and (2) would replace the term “consolidated best bid and offer” as that term is used in Exchange Act Rule 11Ac1-5. This new term refers to the best quotations that are calculated and disseminated by a plan processor

on a real-time or other current and continuing basis, whether through an electronic communications network, moving ticker or interrogation device.” See Exchange Act Rule 11Ac1-2(a)(2).

<sup>385</sup> See Exchange Act Rule 11Ac1-2(a)(2).

<sup>386</sup> The Quote Rule states that “[t]he terms *best bid* and *best offer* shall mean the highest priced bid and the lowest priced offer.” See Exchange Act Rule 11Ac1-1(a)(3). The Vendor Display Rule (Exchange Act Rule 11Ac1-2(a)(15)) defines the terms “best bid” and “best offer” as follows:

(i) With respect to quotations for a reported security, the highest bid or lowest offer for that security made available by any reporting market center pursuant to § 240.11Ac1-1 (Rule 11Ac1-1 under the Act) (excluding any bid or offer made available by an exchange during any period such exchange is relieved of its obligations under paragraphs (b) (1) and (2) of § 240.11Ac1-1 by virtue of paragraph (b)(3)(i) thereof); Provided, however, That in the event two or more reporting market centers make available identical bids or offers for a reported security, the best bid or best offer (as the case may be) shall be computed by ranking all such identical bids or offers (as the case may be) first by size (giving the highest ranking to the bid or offer associated with the largest size), then by time (giving the highest ranking to the bid or offer received first in time); and

(ii) With respect to quotations for a subject security other than a reported security, the highest bid or lowest offer (as the case may be) for such security disseminated by an over-the-counter market maker in Level 2 or 3 of NASDAQ.

pursuant to an effective national market system plan.<sup>387</sup> The definition of “national best bid and national best offer” also would address instances where multiple market centers transmit identical bids and offers to the plan processor pursuant to an NMS plan by establishing the way in which these bids and offers are to be prioritized.<sup>388</sup>

i. Bid or Offer, Customer, Nasdaq Security, and Responsible Broker or Dealer. Regulation NMS also would update or clarify the following terms in the NMS rules: “bid” or “offer;” “customer;” “Nasdaq security;” and “responsible broker or dealer.”

The Quote Rule defines the terms “bid and offer” to mean “the bid price and the offer price communicated by an exchange member or OTC market maker to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of a covered security, as either principal or agent, but shall not include indications of interest.”<sup>389</sup> Regulation NMS would update this definition by replacing the term “OTC market maker” with the phrase “member of a national securities association” and call the term “bid or offer” rather than “bid and offer” to reflect the fact that the terms are not always used in the conjunctive. Modifying the definition to apply to any member of a national securities association would clarify that bids and offers include quotations communicated not only by OTC market makers but also by ATSs, ECNs, and order entry firms that are members of the NASD but that are not market makers.

Expanding the definition of “bid or offer” could have the unintended consequence of also expanding the scope of the Quote Rule (proposed to be redesignated as Rule 602) where those terms are used to apply to members of a national securities association that are not OTC market makers (e.g., ECNs and

<sup>387</sup> The definition of “reporting market center” currently in paragraph (a)(14) of the Vendor Display Rule and incorporated into that Rule’s definitions of “best bid” and “best offer” would no longer be necessary and therefore would be deleted.

<sup>388</sup> See repropoed Rule 600(b)(42).

<sup>389</sup> See Exchange Act Rule 11Ac1-1(a)(4). Paragraph (a)(6) of the Vendor Display Rule uses the Quote Rule’s definition of “bid” and “offer” for reported securities, but it defines “bid” and “offer” for Nasdaq SmallCap securities as “the most recent bid or offer price of an over-the-counter market maker disseminated through Level 2 or 3 of NASDAQ.” Because Nasdaq SmallCap securities now are reported securities, it is unnecessary to maintain the distinction between reported securities and Nasdaq SmallCap securities. Accordingly, to update and provide a single definition of the terms “bid” and “offer,” Regulation NMS would eliminate the definitions of “bid” and “offer” used in the Vendor Display Rule and retain modified versions of the terms as they are defined in the Quote Rule.

ATs). To avoid this unintended expansion of the scope of the Quote Rule (proposed to be redesignated as Rule 602), Regulation NMS repropose a revised version of the Quote Rule's definition of "responsible broker or dealer."<sup>390</sup> In particular, Regulation NMS would amend the portion of the definition of "responsible broker or dealer" found in paragraph (a)(21)(ii) of the Quote Rule<sup>391</sup> to limit its scope to bids and offers communicated by an OTC market maker.

Regulation NMS also would amend the definition of the term "customer." The Quote Rule defines that term to mean "any person that is not a registered broker-dealer."<sup>392</sup> To indicate that the scope of the definition includes broker-dealers that are exempt from registration as well as registered broker-dealers, Regulation NMS would revise the definition by deleting the term "registered." Thus, Regulation NMS would define the term "customer" to mean "any person that is not a broker-dealer."

Exchange Act Rule 11Aa3-1 defines the term "NASDAQ security" to mean "any registered equity security for which quotation information is disseminated in the National Association of Securities Dealers Automated Quotation system ("NASDAQ")."<sup>393</sup> This acronym is now outdated. Therefore, to modernize this definition and to ensure that any type of registered security that Nasdaq lists is covered by the definition, Regulation NMS would define the term "Nasdaq security" to mean "any registered security listed on The Nasdaq Stock Market, Inc."

#### 4. Definitions in the Regulation NMS Rules Reproposed Today

Reproposed Rule 600(b) includes a number of new definitions used in repropose Rules 610 through 612 of Regulation NMS. These new terms are discussed in detail in Sections II through V above. Specifically, for the reasons discussed above, Regulation NMS repropose the following terms: automated quotation, automated trading center, consolidated display, consolidated last sale information, intermarket sweep order, manual quotation, protected bid or protected offer, SRO display-only facility, SRO trading facility, trade-through, and trading center.

#### C. Changes to Other Rules

In addition to the changes described above, the rules repropose today would amend a number of rules that cross-reference current NMS rules or that use terms that Regulation NMS would amend or eliminate. These amendments are intended to be non-substantive. Specifically, the rules repropose today would make conforming changes to the following rules:<sup>394</sup> § 200.30-3;<sup>395</sup> § 200.800, Subpart N;<sup>396</sup> § 201.101;<sup>397</sup> Rule 144<sup>398</sup> under the Securities Act of 1933;<sup>399</sup> Exchange Act Rule 0-10;<sup>400</sup> Exchange Act Rule 3a51-1<sup>401</sup>; Exchange Act Rule 3b-16;<sup>402</sup> Exchange Act Rule 3b-16;<sup>403</sup> Exchange Act Rules 10a-1;<sup>404</sup> Exchange Act Rule 10b-10;<sup>405</sup> Exchange Act Rule 10b-18;<sup>406</sup> Exchange Act Rule 15b9-1;<sup>407</sup> Exchange Act Rule 12a-7;<sup>408</sup> Exchange Act Rule 12f-1;<sup>409</sup> Exchange Act Rule 12f-2;<sup>410</sup> Exchange Act Rule 15c2-11;<sup>411</sup> Exchange Act Rule 19c-3;<sup>412</sup> Exchange Act Rule 19c-

<sup>394</sup> § 200.800, Subpart N, § 201.101, Exchange Act Rules 0-10, 3a51-1(e), 3a55-1, 10a-1, and 31, and Rule 17a-7 under the Investment Company Act of 1940 are in addition to those included in the Proposing Release.

<sup>395</sup> 17 CFR 200.30-3. In addition to conforming changes, the Commission is repropose to amend this rule to grant the Director of the Division of Market Regulation the authority to grant exemptions to Rules 610 through 612.

<sup>396</sup> 17 CFR 200.800, Subpart N.

<sup>397</sup> 17 CFR 201.101.

<sup>398</sup> 17 CFR 230.144.

<sup>399</sup> 15 U.S.C. 77a *et seq.*

<sup>400</sup> 17 CFR 240.0-10.

<sup>401</sup> 17 CFR 240.3a51-1.

<sup>402</sup> 17 CFR 240.3a55-1. Section 3(a)(55)(C)(vi) under the Exchange Act and Section 1a(25)(B)(vi) of the Commodity Exchange Act ("CEA") provide that an index is not a narrow-based security index if a future on the index is traded on or subject to the rules of a board of trade and meets such requirements as are established by rule, regulation, or order jointly by the two Commissions. Pursuant to this authority, the Commission and the Commodity Futures Trading Commission ("CFTC") jointly adopted Exchange Act Rule 3a55-1 and CEA Rule 41.11. The Commission today is proposing to substitute "NMS securities, as defined in § 242.600," for "reported securities, as defined in § 240.11Ac1-1" in Exchange Act Rule 3a55-1. The new term "NMS security" is proposed to be defined in § 242.600 the same as the term "reported security" is defined in current Exchange Act Rule 11Ac1-1. Accordingly, the proposed changes to Rule 3a55-1 are technical. If the Commission adopts Regulation NMS, the changes to Rule 3a55-1, and identical changes to CEA Rule 41.11, would need to be adopted jointly by the Commission and the CFTC.

<sup>403</sup> 17 CFR 240.3b-16.

<sup>404</sup> 17 CFR 240.10a-1.

<sup>405</sup> 17 CFR 240.10b-10.

<sup>406</sup> 17 CFR 240.10b-18.

<sup>407</sup> 17 CFR 240.15b9-1.

<sup>408</sup> 17 CFR 240.12a-7.

<sup>409</sup> 17 CFR 240.12f-1.

<sup>410</sup> 17 CFR 240.12f-2.

<sup>411</sup> 17 CFR 240.15c2-11.

<sup>412</sup> 17 CFR 240.19c-3.

4;<sup>413</sup> Exchange Act Rule 31;<sup>414</sup> Rule 100 of Regulation M under the Exchange Act;<sup>415</sup> Rule 300 of Regulation ATS under the Exchange Act;<sup>416</sup> Rule 301 of Regulation ATS under the Exchange Act;<sup>417</sup> § 249.1001;<sup>418</sup> and Rule 17a-7 under the Investment Company Act of 1940.<sup>419</sup>

#### VII. General Request for Comment

In addition to any specific requests for comment included above, the Commission generally requests comment on all aspects of the repropose described above. Interested persons are invited to submit written presentations of views, data, and arguments concerning the repropose, including the feasibility and practicality of implementing the repropose and the costs and benefits associated with the repropose. In addition, the Commission will continue to accept comment on all issues that were previously raised in the Proposing Release and Supplemental Release. Finally, the Commission requests comment, assuming it were to adopt the repropose, on the nature and length of implementation and phase-in periods that would be appropriate to allow market participants time to adapt to the new regulatory structure and implement the repropose in an efficient and orderly manner. The Commission will consider all comments previously submitted in response to the Proposing Release, the Hearing, and the Supplemental Release, in addition to all comments received in response to this release, in evaluating any further action taken on Regulation NMS.

#### VIII. Paperwork Reduction Act

##### A. Trade-Through Rule

The repropose Trade-Through Rule contains collection of information requirements within the meaning of the Paperwork Reduction Act of 1995.<sup>420</sup> The Commission published a notice requesting comment on the collection of information requirements in the Proposing Release, and submitted these requirements to the Office of Management and Budget ("OMB") for

<sup>413</sup> 17 CFR 240.19c-4.

<sup>414</sup> 17 CFR 240.31.

<sup>415</sup> 17 CFR 242.100.

<sup>416</sup> 17 CFR 242.300.

<sup>417</sup> 17 CFR 242.301. The Commission also is proposing a technical change to Rule 301(b)(3)(iii) of Regulation ATS to correct a cross-reference to Rule 301(b)(3)(ii)(A) by deleting the reference to subparagraph (A). This change would not have any substantive effect.

<sup>418</sup> 17 CFR 249.1001.

<sup>419</sup> 17 CFR 270.17a-7.

<sup>420</sup> 44 U.S.C. 3501 *et seq.* ("Paperwork Reduction Act").

<sup>390</sup> See Exchange Act Rule 11Ac1-1(a)(21).

<sup>391</sup> See Exchange Act Rule 11Ac1-1(a)(21)(ii).

<sup>392</sup> See Exchange Act Rule 11Ac1-1(a)(26).

<sup>393</sup> See Exchange Act Rule 11Aa3-1(a)(6).

review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The Commission is resubmitting these requirements to the OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, an information collection unless it displays a currently valid OMB control number. The title of the affected collection is "Order Protection Rule" under OMB control number 3235-0600.<sup>421</sup>

In the Proposing Release, the Commission proposed to create three new information collections. The first collection of information arose from the proposed requirement that trading centers<sup>422</sup> adopt policies and procedures reasonably designed to prevent the execution of a transaction at prices inferior to prices displayed by other trading centers. The other two collections of information related to requirements in a proposed exception to the Trade-Through Rule included in the Proposing Release—the opt-out exception.<sup>423</sup> The revised Trade-Through proposal does not contain an opt-out exception, and therefore, the collections of information associated with the proposed opt-out exception are no longer applicable.<sup>424</sup>

The Commission has revised the discussion below to reflect the requirements of the repropoed Trade-Through Rule.

#### 1. Summary of Collection of Information

The repropoed Trade-Through Rule would require a trading center to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by other trading centers, unless a valid exception applies, and, if relying on such an exception, that are reasonably designed to assure compliance with the terms of the exception. The nature and extent of the policies and procedures that a trading center would be required to establish to comply with this requirement would depend upon the

<sup>421</sup> See *supra* note 9.

<sup>422</sup> In the Proposing Release, the Commission used the term "order execution facility" to describe the entities that would be subject to the proposed rule. In the revised proposal, these entities are referred to as "trading centers." Specifically, a "trading center" would be defined to mean a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent. See repropoed Rule 600(b)(78).

<sup>423</sup> See Section III.G.1. of the Proposing Release.

<sup>424</sup> See *supra* Section II.A.4.

type, size, and nature of the trading center.

#### 2. Proposed Use of Information

The requirement that each trading center establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by other trading centers or to assure compliance with the terms of an exception would help ensure that the trading center and its customers, subscribers, members, and employees, as applicable, generally avoid engaging in trade-throughs, unless a valid exception is applicable.

#### 3. Respondents

The requirement for each trading center to establish written policies and procedures reasonably designed to prevent the execution of trade-throughs potentially would apply to eight registered national securities exchanges that trade NMS stocks and the NASD,<sup>425</sup> and approximately 600 broker-dealers registered with the Commission.<sup>426</sup> The Commission requests comment on the accuracy of these figures.

The Commission has considered each of these respondents for the purposes of calculating the reporting burden under the repropoed Trade-Through Rule.

#### 4. Total Annual Reporting and Recordkeeping Burden

The Commission has modified the estimated total annual reporting and recordkeeping burden for this collection of information to take into account changes made to the repropoed Trade-Through Rule. The revisions relate to the burden necessary to establish written policies and procedures reasonably designed to assure compliance with the exceptions

<sup>425</sup> There are eight national securities exchanges (Amex, BSE, CBOE, CHX, NSX, NYSE, Phlx and PCX) and one national securities association (NASD) that trade NMS stocks and thus would be subject to the repropoed Rule. The ISE does not trade NMS stocks and thus would not be subject to the repropoed Rule.

<sup>426</sup> After further analysis, the Commission has revised the estimated number of broker-dealers that would be subject to the repropoed Trade-Through Rule. The revised number includes the approximately 585 firms that were registered equity market makers or specialists at year-end 2003 (this number was derived from annual FOCUS reports and discussion with SRO staff), as well as ATSS that operate trading systems that trade NMS stocks. The Commission preliminarily believes it is reasonable to assume that in general, firms that are block positioners—*i.e.*, firms that are in the business of executing orders internally—are the same firms that are registered market makers (for instance, they may be registered as a market maker in one or more Nasdaq stocks and carry on a block positioner business in exchange-listed stocks), especially given the amount of capital necessary to carry on such a business.

contained in the repropoed Rule. Thus, trading centers would need to develop written policies and procedures for preventing and monitoring for trade-throughs that do not fall within an enumerated exception, and, if relying on such an exception, that are reasonably designed to assure compliance with the terms of the exception, to assure that they are in compliance with the Rule.

Although the exact nature and extent of the required policies and procedures that a trading center would be required to establish likely would vary depending upon the nature of the trading center (*e.g.*, SRO vs. non-SRO, full service broker-dealer vs. market maker), the Commission broadly estimates that it would take an SRO trading center approximately 270 hours of legal,<sup>427</sup> compliance,<sup>428</sup> information technology<sup>429</sup> and business operations personnel<sup>430</sup> time,<sup>431</sup> and a non-SRO

<sup>427</sup> Based on industry sources, the Commission estimates that the average hourly rate for outsourced legal service in the securities industry is between \$150 per hour and \$300 per hour. For purposes of this Release, the Commission will use the highest rate of \$300 per hour to determine potential outsourced legal costs associated with the proposed rule. For in-house legal services, the Commission estimates that the average hourly rate for an attorney in the securities industry is approximately \$82 per hour. The \$82 per hour figure for an attorney is from the Securities Industry Association, *Report on Management & Professional Earnings in the Securities Industry 2003* (Sept. 2003), adjusted by the SEC staff for an 1800-hour work-year with a 35% upward adjustment for overhead, reflecting the cost of supervision, space, and administrative support.

<sup>428</sup> The Commission estimates that the average hourly rate for an assistant compliance director in the securities industry is approximately \$103 per hour. The \$103 per hour figure for an assistant compliance director is from the Securities Industry Association, *Report on Management & Professional Earnings in the Securities Industry 2003* (Sept. 2003), adjusted by the SEC staff for an 1800-hour work-year with a 35% upward adjustment for overhead, reflecting the cost of supervision, space, and administrative support.

<sup>429</sup> The Commission estimates that the average hourly rate for a senior computer programmer in the securities industry is approximately \$67 per hour. The \$67 per hour figure for a senior computer programmer is from the Securities Industry Association, *Report on Management & Professional Earnings in the Securities Industry 2003* (Sept. 2003), adjusted by the SEC staff for an 1800-hour work-year with a 35% upward adjustment for overhead, reflecting the cost of supervision, space, and administrative support.

<sup>430</sup> The Commission estimates that the average hourly rate for an operations manager in the securities industry is approximately \$70 per hour. The \$70 per hour figure for an operations manager is from the Securities Industry Association, *Report on Management & Professional Earnings in the Securities Industry 2002* (Sept. 2002), adjusted by the SEC staff for an 1800-hour work-year with a 35% upward adjustment for overhead, reflecting the cost of supervision, space, and administrative support.

<sup>431</sup> The Commission anticipates that of the 270 hours it estimates would be spent to establish the required policies and procedures, 120 hours would

trading center approximately 210 hours of legal, compliance, information technology and business operations personnel time,<sup>432</sup> to develop the required policies and procedures.

Included within this estimate, the Commission expects that SRO and non-SRO respondents may incur one-time external costs for out-sourced legal services. While the Commission recognizes that the amount of legal outsourcing utilized to help establish written policies and procedures may vary widely from entity to entity, it estimates that on average, each trading center would outsource 50 hours of legal time in order to establish policies and procedures in accordance with the repropoed Rule.

The Commission estimates that there would be an initial one-time burden of 220 burden hours per SRO trading center or 1,980 hours,<sup>433</sup> and 160 burden hours per non-SRO trading center<sup>434</sup> or 96,000 hours, for a total of 97,980 burden hours to establish policies and procedures reasonably designed to prevent the execution of a trade-through, for an estimated one-time initial cost of \$8,646,405.<sup>435</sup> The Commission estimates a capital cost of approximately \$9,135,000 for both SRO and non-SRO trading centers resulting from outsourced legal work<sup>436</sup> for a total one-time initial cost of \$17,781,405.<sup>437</sup>

Once a trading center has established written policies and procedures

be spent by legal personnel, 105 hours would be spent by compliance personnel, 20 hours would be spent by information technology personnel and 25 hours would be spent by business operations personnel of the SRO trading center.

<sup>432</sup> The Commission anticipates that of 210 hours it estimates would be spent to establish policies and procedures, 87 hours would be spent by legal personnel, 77 hours would be spent by compliance personnel, 23 hours would be spent by information technology personnel and 23 hours would be spent by business operations personnel of the non-SRO trading center.

<sup>433</sup> The estimated 1,980 burden hours necessary for SRO trading centers to establish policies and procedures are calculated by multiplying nine times 220 hours ( $9 \times 220 \text{ hours} = 1,980 \text{ hours}$ ).

<sup>434</sup> The estimated 96,000 burden hours necessary for non-SRO trading centers to establish policies and procedures are calculated by multiplying 600 times 160 hours ( $600 \times 160 \text{ hours} = 96,000 \text{ hours}$ ).

<sup>435</sup> This figure was calculated as follows: (70 legal hours  $\times$  \$82) + (105 compliance hours  $\times$  \$103) + (20 information technology hours  $\times$  \$67) + (25 business operation hours  $\times$  \$70) = \$19,645 per SRO  $\times$  9 SROs = \$176,805 total cost for SROs; (37 legal hours  $\times$  \$82) + (77 compliance hours  $\times$  \$103) + (23 information technology hours  $\times$  \$67) + (23 business operation hours  $\times$  \$70) = \$14,116 per broker-dealer  $\times$  600 broker-dealers = \$8,469,600 total cost for broker-dealers, \$176,805 + \$8,469,600 = \$8,646,405.

<sup>436</sup> This figure was calculated as follows: (50 legal hours  $\times$  \$300  $\times$  9 SROs) + (50 legal hours  $\times$  \$300  $\times$  600 broker-dealers) = \$9,135,000.

<sup>437</sup> This figure was calculated by adding \$8,646,405 and \$9,135,000.

reasonably designed to prevent trade-throughs in its market, the Commission estimates that it would take the average SRO and non-SRO trading center approximately two hours per month of internal legal time and three hours of internal compliance time to ensure that its written policies and procedures are up-to-date and remain in compliance with repropoed Rule 611. The Commission staff estimates that these ongoing costs would be 60 hours annually per respondent, for a total estimated annual cost of \$3,456,684.<sup>438</sup>

#### 5. General Information About Collection of Information

This collection of information would be mandatory. The Commission expects that the written policies and procedures that would be generated pursuant to repropoed Rule 611 would be communicated to the members, subscribers, and employees (as applicable) of all entities covered by the repropoed Rule. To the extent that this information is made available to the Commission, it would not be kept confidential. Any records generated in connection with the repropoed Rule's requirement to establish written policies and procedures would be required to be preserved in accordance with, and for the periods specified in, Exchange Act Rules 17a-1<sup>439</sup> and 17a-4(e)(7).<sup>440</sup>

#### 6. General Request for Comment

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

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

<sup>438</sup> This figure was calculated as follows: (2 legal hours  $\times$  12 months  $\times$  \$82)  $\times$  (9 + 600) + (3 compliance hours  $\times$  12 months  $\times$  \$103)  $\times$  (9 + 600) = \$3,456,684.

<sup>439</sup> 17 CFR 240.17a-1.

<sup>440</sup> 17 CFR 240.17a-4(e)(7).

Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609, with reference to File No. S7-10-04. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7-10-04, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549-0609. As OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

#### B. Access Rule

In the Proposing Release, the Commission requested comment on its preliminary view that proposed Rule 610 and the proposed amendment to Rule 301(b)(5) under Regulation ATS do not contain a collection of information requirement as defined by the Paperwork Reduction Act.<sup>441</sup> No comments were submitted that addressed the issue. The Commission continues to believe that repropoed Rule 610 and the repropoed amendment to Rule 301(b)(5) do not contain a collection of information requirement.

#### C. Sub-Penny Rule

In the Proposing Release, the Commission stated its preliminary view that proposed Rule 612 does not contain a collection of information requirement as defined by the Paperwork Reduction Act.<sup>442</sup> Although the Commission solicited comment on the PRA implications of the proposed Sub-Penny Rule, no commenters addressed this issue. The Commission continues to believe that repropoed Rule 612 does not contain a collection of information requirement.

#### D. Market Data Rules and Plan Amendments

In the Proposing Release, the Commission stated its preliminary view that the proposed amendments to the joint-industry plans and to Exchange Act Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) do not impose a collection of information requirement as defined

<sup>441</sup> Proposing Release, 69 FR at 11160.

<sup>442</sup> Proposing Release, 69 FR at 11172.

by the Paperwork Reduction Act.<sup>443</sup> No comments were received that addressed this issue. The Commission continues to believe that these repropoed amendments do not contain a collection of information requirement.

#### E. Regulation NMS

In the Proposing Release, the Commission stated its preliminary view that proposed Rule 600, the redesignation of the NMS rules, and the conforming amendments to various rules do not impose a collection of information requirement as defined by the Paperwork Reduction Act.<sup>444</sup> No comments were received that addressed this issue. The Commission continues to believe that these proposed amendments do not contain a collection of information requirement.

### IX. Consideration of Costs and Benefits

In the Proposing Release, the Commission identified certain costs and benefits of the Regulation NMS proposals, and, to help evaluate the costs and benefits, requested comment on all aspects of the costs and benefits and encouraged commenters to identify or supply any relevant data concerning the costs or benefits of the proposal.<sup>445</sup> To the extent commenters discussed costs and benefits, the Commission has considered those comments. The Commission renews its request for comments on the costs and benefits of the Regulation NMS proposals. The Commission encourages commenters to identify, discuss, analyze, and supply relevant data concerning the costs or benefits of the repropoed rules.

#### A. Trade-Through Rule

Repropoed Rule 611 would require a trading center (which includes national securities exchanges and national securities associations that operate SRO trading facilities, ATs, market makers, and block positioners) to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs of protected quotations, and, if relying on an exception, that are reasonably designed to assure compliance with the terms of the exception. To qualify for protection, a quotation would be required to be displayed and immediately accessible through automatic execution. The repropoed Rule also would require a trading center to regularly surveil to ascertain the effectiveness of the policies and

procedures and to take prompt remedial action to remedy deficiencies in such policies and procedures.

Repropoed Rule 611 would include a variety of exceptions to make intermarket price protection as efficient and workable as possible. These would include an intermarket sweep exception, which would allow market participants simultaneously to access multiple price levels at different trading centers—a particularly important function now that trading in penny increments has dispersed liquidity across multiple price levels. The intermarket sweep exception would enable trading centers that receive sweep orders to execute those orders immediately, without waiting for better-priced quotations in other markets to be updated. In addition, repropoed Rule 611 would, among other things, provide exceptions for the quotations of trading centers experiencing a material delay (generally of more than one second) in providing a response to incoming orders, as well as for flickering quotations with prices that have been displayed for less than one second.

#### 1. Benefits

Many commenters supported the adoption of a uniform rule against trade-throughs for all NMS stocks and discussed the benefits that such a rule would bring to the markets.<sup>446</sup> These commenters noted that such a uniform rule would encourage the use of displayed limit orders, thus increasing depth and liquidity in the market.<sup>447</sup> Some of these commenters also stated that the trade-through proposal would increase investor confidence by helping to eliminate the impression of unfairness when an investor's order executes at a price that is worse than another displayed order, or when a trade occurs at a price that is inferior to the investor's displayed order.<sup>448</sup> As discussed above in Section II.A.1, the Commission preliminarily agrees with these commenters.

The Commission preliminarily believes that the repropoed Trade-Through Rule would enhance the overall fairness and efficiency of the NMS and produce significant benefits for investors. By providing greater protection for displayed prices, the repropoed Rule would serve to enhance the depth and liquidity of the NMS, and thus contribute to the maintenance of fair and orderly markets.

By better protecting the interests of investors, both those that post limit orders and those that execute against posted limit orders, the repropoed Rule would promote investor confidence in the NMS. The repropoed Rule would be a significant improvement over the existing ITS trade-through rule, and would level the competitive playing field among markets by eliminating the potential advantage that the ITS rule afforded to manual markets.

The Commission preliminarily believes that the proposed Trade-Through Rule is necessary to, and would serve to, enhance protection of displayed prices. Investors who post limit orders, and trading centers that quote aggressively, should not see trades occurring on another market at a price inferior to their orders, except in circumstances where an exception applies. By requiring trading centers to establish written policies and procedures reasonably designed to prevent trade-throughs and to comply with exceptions, and by requiring them to regularly surveil to ascertain the effectiveness of the policies and procedures and to take prompt remedial action to remedy deficiencies in such policies and procedures, the repropoed Rule should help ensure that displayed limit orders are not routinely bypassed by transactions occurring in other markets at inferior prices. By providing this protection for displayed prices, the Rule would serve to promote greater display of limit orders and more aggressive quoting. An increase in the use of limit orders and aggressive quoting should enhance price discovery and depth and liquidity in the markets; greater depth and liquidity would lead to improved execution quality for marketable orders, particularly for the execution of large institutional orders where statistics show there is room for improvement in both the markets for the trading of Nasdaq and exchange-listed stocks.<sup>449</sup>

Comment is requested on whether extending trade-through protection to DOB quotations<sup>450</sup> would significantly increase the benefits of the repropoed Trade-Through Rule. Would protecting quotations at multiple price levels further encourage the display of limit orders and thereby significantly enhance depth and liquidity in the NMS? Since decimalization, quoted spreads have narrowed substantially. Market participants often may not be willing to quote in significant size at the inside prices, but might be willing to do so at a price that is a penny or more

<sup>443</sup> See *supra* Section II.A.1.

<sup>444</sup> See, e.g., BNY Letter at 2; Consumer Federation Letter at 2; ICI Letter at 7.

<sup>445</sup> See, e.g., Consumer Federation Letter at 2; ICI Letter at 7.

<sup>449</sup> See *supra* Section II.A.1.

<sup>450</sup> See *supra* Section II.A.5.

<sup>443</sup> Proposing Release, 69 FR at 11186.

<sup>444</sup> Proposing Release, 69 FR at 11197.

<sup>445</sup> Proposing Release, 69 FR at 11148–11150, 11161, 11172–73, 11186–89, 11197–98.

away from the inside prices. Granting trade-through protection to such quotations potentially would reward this beneficial quoting activity. In assessing the potential benefits of DOB protection, commenters should consider the effect of the reserve (or undisplayed) size function that many trading centers offer investors.<sup>451</sup>

By requiring trading centers to establish written policies and procedures reasonably designed to prevent trade-throughs and to comply with exceptions, and by requiring them to regularly surveil to ascertain the effectiveness of the policies and procedures and to take prompt remedial action to remedy deficiencies in such policies and procedures, the repropoed Rule also should help ensure that investors that submit marketable orders consistently receive executions at the best displayed bid or offer (or better). The Rule should facilitate the ability of a broker-dealer to achieve best execution for its customer orders because the market to which a broker-dealer routes an order would not execute the order at a price that is inferior to a protected bid or offer displayed on the other market (unless an exception applies).<sup>452</sup> By better protecting the interests of all investors—both those that post limit orders and those that execute against posted limit orders—the repropoed Rule should bolster investor confidence in the integrity of the NMS, which should encourage investors to be more willing

<sup>451</sup> For example, Market A may be displaying a best offer of 1000 shares at \$10.00, and DOB offers of 2000 shares at \$10.01 and 2000 shares at \$10.02. With a reserve size function, however, Market A may have an additional 1000 shares offered at \$10.00 and an additional 2000 shares offered at \$10.01, neither of which is displayed. Assuming the displayed offers of \$10.00, \$10.01, and \$10.02 were protected quotations under the Voluntary Depth Alternative, Market B could execute a trade at \$10.03 only by simultaneously routing an order to execute against the accumulated displayed size of the protected quotations at Market A. Market B therefore would be required to route a buy order, identified as an intermarket sweep order, to Market A with a limit price of \$10.02 for a total of 5000 shares (the accumulated amount of the displayed size of protected quotations with a price of \$10.02 or better at Market A). Under the priority rules currently in effect at electronic markets, undisplayed size has priority over displayed size at an inferior price. Accordingly, Market A would execute the 5000 share buy order as follows: 2000 shares at \$10.00 (1000 displayed plus 1000 reserve) and 3000 shares at \$10.01 (2000 displayed plus 1000 reserve). While Market B would have complied with the Rule, the displayed \$10.02 offer at Market A would still go unfilled when Market B traded at \$10.03. Comment is requested on the extent to which this outcome would detract from the benefits of the Voluntary Depth Alternative.

<sup>452</sup> The Commission emphasizes that adoption of repropoed Rule 611 would in no way lessen a broker-dealer's duty of best execution. See *supra* section II.B.4.

to invest in the market, thus adding depth and liquidity to the markets and promoting the ability of listed companies to raise capital.

Almost all commenters agreed that the current ITS trade-through rule must be fixed to accommodate the realities of today's NMS, in particular the differences in operation among automated and non-automated markets. Repropoed Rule 611, by providing protection only for automated quotations displayed by automated trading centers, would significantly update the ITS trade-through rule. Intermarket efficiency and certainty of execution in the NMS would be improved as automated markets would no longer need to wait for responses from non-automated markets and thus would be able to execute trades more quickly without regard for potentially unavailable quotations displayed on non-automated markets. The repropoed Rule also would level the playing field by eliminating the potential competitive advantage the existing ITS rule provides to manual markets. In addition, by providing an incentive for non-automated markets to automate—because market participants may be less likely to send their order flow to a market center whose orders can be ignored by other markets—the proposed Rule generally should improve the accessibility of bids and offers for all investors and increase the efficiency of the NMS.

When an investor receives an execution in one market at a price that is inferior to a price displayed in another market, that “trade-through” has a cost to the investor receiving the inferior execution. The Commission preliminarily believes that the benefits of strengthening price protection for exchange-listed stocks (by eliminating the gaps in ITS coverage of block positioners and 100-share quotes) and introducing price protection for Nasdaq stocks would be substantial, although the total amount is difficult to quantify. One objective, though quite conservative, estimate of benefits is the dollar amount of quotations that currently are traded through. Commission staff's analysis of current trade-through rates indicates that over 12 billion shares of displayed quotations in Nasdaq and NYSE stocks were traded through in 2003, by an average amount of 2.3 cents for Nasdaq stocks and 2.2 cents for NYSE stocks.<sup>453</sup> These traded-through quotations represent approximately \$209 million in Nasdaq stocks and \$112 million in NYSE stocks, for a total of \$321 million in bypassed

limit orders and inferior prices for investors in 2003 that could have been addressed by strong trade-through protection. The Commission preliminarily believes that this \$321 million estimated annual benefit, particularly when combined with the benefits of enhanced investor confidence in the fairness and orderliness of the equity markets, would justify the one-time costs of implementation and ongoing annual costs of the repropoed Trade-Through Rule.

The foregoing estimate of annual benefits is very conservative because it is based solely on depth of quotations that are displayed in the *absence* of strong price protection. In essence, it measures the problem—a shortage of quoted depth—that repropoed Rule 611 is designed to address, rather than the benefits that it would achieve. Every trade-through transaction potentially sends a message to market participants that their displayed quotations can be and are ignored by other market participants. When the total share volume of trade-through transactions that do not interact with displayed quotations reaches 8% and above for hundreds of the most actively traded NMS stocks, this message is unlikely to be missed by those who watched their quotations being traded through. Certainly, the practice of trading through displayed size is most unlikely to prompt market participants to display even greater size.

As discussed above,<sup>454</sup> a primary objective of repropoed Rule 611 is to increase displayed depth and liquidity in the NMS and thereby reduce trading costs for a wide spectrum of investors, particularly institutional investors that trade in large sizes. It is difficult, however, to precisely measure the extent to which strengthened price protection would improve market depth and liquidity, and thereby lower trading costs of investors. The difficulty of estimation, however, should not hide from view the enormous potential benefit for investors of improving depth and efficiency of the NMS. Because of the huge dollar amount of trading volume in NMS stocks—more than \$17 trillion in 2003<sup>455</sup>—even the most incremental improvement in market depth and liquidity could generate a dollar amount of benefits that *annually* would dwarf the one-time start-up costs of implementing trade-through protection.

<sup>454</sup> *Id.*

<sup>455</sup> World Federation of Exchanges, Annual Report (2003), at 86.

<sup>453</sup> See *supra* Section II.A.1.

One approach to evaluating the potential benefits of the repropoed Rule is to examine a category of investors that stand to benefit a great deal from improved depth and liquidity for NMS stocks—the shareholders of U.S. equity mutual funds. In 2003, the total assets of such funds were \$3.68 trillion.<sup>456</sup> The average portfolio turnover rate for equity funds was 55%, meaning that the total purchases and sales of the securities they held total approximately \$4.048 trillion.<sup>457</sup> A leading authority on the trading costs of institutional investors has estimated that in 2003 the average price impact experienced by investment managers in U.S. stocks ranged from 17.4 basis points for giant-capitalization stocks, 21.4 basis points for large-capitalization stocks, and up to 35.4 basis points for micro-capitalization stocks.<sup>458</sup> In addition, it estimated the cost attributable to adverse price movements while searching for liquidity for institutional orders, which often are too large simply to be presented to the market. Its estimate of search costs ranged from 13 basis points for giant capitalization stocks, 23 basis points for large capitalization stocks, and up to 119 basis points for micro-capitalization stocks. Assuming that the average price impact and search costs incurred across all stocks is a conservative 37.4 basis points,<sup>459</sup> the shareholders in U.S. equity mutual funds incurred implicit trading costs of \$15.1 billion in 2003. Based on a hypothetical assumption that, in light of the current share volume of trade-through transactions that does not interact with displayed liquidity,<sup>460</sup> intermarket trade-through protection could improve depth and liquidity for NMS stocks by at least 5% (or an average reduction of 1.87 basis points in price impact and liquidity search costs for large investors), the savings in trading costs for U.S. equity mutual funds alone, and the improved returns for their millions of individual

shareholders, would have amounted to approximately \$755 million in 2003.

Of course, the benefits of improved depth and liquidity for the direct equity holdings of other types of investors, such as pension funds, insurance companies, and individuals, are not incorporated in the foregoing calculations. In 2003, these other types of investors held 78% of the value of publicly traded U.S. equity outstanding, with equity mutual funds holding the remaining 22%.<sup>461</sup> Assuming that these other types of investors experienced a reduction in trading costs that merely equaled the estimated reduction of trading costs for equity mutual funds, the assumed 5% improvement in market depth and liquidity could yield total trading cost savings of over \$1.5 billion annually. Such savings would improve the investment returns of equity ownership, thereby promoting the retirement and other long-term financial interests of individual investors and reducing the cost of capital for listed companies.

## 2. Costs

Some commenters expressed concern over the anticipated cost of implementing the trade-through proposal.<sup>462</sup> These commenters argued that proposed Rule 611 would be too expensive and that the costs associated with implementing it would outweigh the perceived benefits of the rule. Some commenters were concerned about the cost of specific requirements in the proposed rule, particularly the procedural requirements associated with the proposed opt-out exception (e.g., obtaining informed consent from customers and disclosing the NBBO to customers).<sup>463</sup> As discussed above, however, the repropoed Trade-Through Rule does not contain an opt-out exception, as was originally proposed.<sup>464</sup> Therefore, the concerns expressed by commenters relating to the costs of implementing an opt-out exception are not applicable. Commenters also expressed concern that applying the trade-through proposal to the Nasdaq market would harm market efficiency and execution

quality.<sup>465</sup> As discussed above, the Commission preliminarily believes that a uniform rule that serves to limit the incidence of trade-throughs would improve market efficiency and benefit execution quality.<sup>466</sup>

The Commission recognizes that there would be significant one-time costs to implement the repropoed Trade-Through Rule. Trading centers would necessarily incur costs associated with establishing, maintaining, and enforcing written policies and procedures reasonably designed to prevent trade-throughs—in other words, with determining a course of action for how the trading center would comply with the requirements of the Rule, including compliance with the exceptions contained in the repropoed Rule. Although the extent of these costs would vary because the exact nature and extent of each trading center's written policies and procedures would depend on the type, size and nature of each entity's business, as discussed above in Section VIII.A., for purposes of the PRA the Commission broadly estimates that each SRO trading center would incur an average one-time initial cost for establishing such policies and procedures of approximately \$34,645, and each non-SRO trading center would incur an average one-time initial cost for establishing policies and procedures of approximately \$29,116, for a total of \$17,781,405.<sup>467</sup>

Each trading center also would incur initial up-front costs associated with taking action necessary to implement the written policies and procedures it has developed, which would include necessary modifications to order routing and execution systems to “hard-code” compliance with the Rule and the exceptions. For instance, modifications to order routing and execution systems would need to be made to route and execute orders in compliance with the requirements of the proposed Rule to prevent trade-throughs of protected quotations (which would include, for instance, the ability to recognize quotations identified in the consolidated quotation system as manual quotations on a quotation-by-quotation basis). Trading centers would need to make sure they have connectivity to other trading centers in

<sup>456</sup> Mutual Fund Fact Book, *supra* note 135 at 55.

<sup>457</sup> *Id.* at 64. Portfolio turnover is measured by adding total fund purchases and sales, dividing by 2, and then dividing by total fund assets. Because price impact occurs for both purchases and sales, the turnover rate must be doubled, then multiplied by total fund assets, to measure the total value of trading that is affected by price impact costs.

<sup>458</sup> Plexus Group, Inc., Commentary 80, “Trading Truths: How Mis-Measurement of Trading Costs Is Leading Investors Astray,” (April 2004), at 2.

<sup>459</sup> The estimate of 37.4 basis points is the average of the total market impact and liquidity search costs for giant capitalization stocks (30.4 basis points) and the total market impact and liquidity search costs for large capitalization stocks (44.4 basis points). The much higher market impact and liquidity search costs of midcap, smallcap, and microcap stocks are not included.

<sup>460</sup> See *supra* Section II.A.1.

<sup>461</sup> Mutual Fund Fact Book, *supra* note 135 at 59.

<sup>462</sup> See, e.g., Bloomberg Tradebook Letter at 14; Fidelity Letter I at 12; Instinet Letter at 14, 15; Nasdaq Letter II at 2; Peake Letter I at 2; Reg NMS Study Group Letter at 4; Rosenblatt Securities Letter II at 4; STANY Letter at 3; UBS Letter at 8.

<sup>463</sup> See, e.g., Ameritrade Letter I at 8; Brut Letter at 10–12; Citigroup Letter at 8–9; E\*TRADE Letter at 7; Financial Information Forum Letter at 2; JP Morgan Letter at 4; SIA Letter at 12–15.

<sup>464</sup> See *supra* Section II.A.4.

<sup>465</sup> See, e.g., Citadel Letter at 6; Hudson River Trading Letter at 1–2; Instinet Letter at 12, 14; Nasdaq Letter II at 1–2, 5.

<sup>466</sup> See *supra* Section II.A.1.

<sup>467</sup> See *supra* notes 431 to 437 and accompanying text. As with any new Commission rule, trading centers also would have to take steps to educate and train their employees as to the scope and impact of, and how to comply with, the repropoed Rule and the policies and procedures implemented by the trading center.



the NMS that could post protected quotations, whether through proprietary linkages or through use of third-party services. As noted below, however, the Commission preliminarily believes that most of this private linkage functionality already exists, particularly in the market for Nasdaq securities. Surveillance systems would need to be modified to assure an effective mechanism for monitoring transactions after-the-fact for ongoing compliance purposes. Also, trading systems would need to be programmed to recognize when exceptions to the operative provisions of repropoed Rule 611 were applicable. For example, trading centers would need to be able to identify outgoing and recognize incoming orders as intermarket sweep orders. Data feeds and market vendor systems would need to be modified to accommodate order identifiers for manual quotations and intermarket sweep orders, which costs (to the extent incurred) would likely be passed along to the end users of these systems, the trading centers. These costs are included within the estimates below.

For non-SRO trading centers that rely upon their own internal order routing and execution management systems, of which the Commission preliminarily estimates that there are approximately 20, the Commission preliminarily estimates the average cost of necessary systems changes to implement the Rule would be approximately \$3 million per trading center, for a total one-time start-up cost of approximately \$60 million.<sup>468</sup> The Commission preliminarily estimates that the remaining non-SRO trading centers that would be subject to the repropoed Rule would utilize outside vendors to provide these services, consistent with their current use of such services for order routing and execution management. For these non-SRO trading centers, the Commission preliminarily estimates the cost of necessary systems modifications that would be passed along to the trading centers to be approximately \$50,000 per trading center, for a total initial cost of \$21 million.<sup>469</sup> The

<sup>468</sup> This number is an average estimated cost; thus, it would overestimate the costs for some trading centers and underestimate it for others. For instance, it likely overestimates the cost for ATS trading centers, particularly smaller ones, as opposed to full-service broker-dealer trading centers, in part because of the narrower business focus of some ATSs.

<sup>469</sup> Given that floor-based market-makers and specialists utilize exchange execution systems, the Commission preliminarily believes it is reasonable to assume that such market-makers and specialists would not incur substantial systems-related costs to implement the repropoed Rule independent of the costs that would be incurred by the exchange on

Commission also preliminarily estimates that the average cost to the nine SROs to make necessary system modifications to implement the repropoed Rule would be \$5 million per SRO, for a total of \$45 million. Therefore, preliminary estimated overall total one-time implementation costs, added to PRA costs, would be approximately \$144 million.

In addition, broker-dealers that would not fall within the proposed definition of a trading center but that employ their own smart-order routing technology to route orders to multiple trading centers could choose to route orders in compliance with the proposed intermarket sweep exception. These broker-dealers would need to make necessary modifications to their order routing practices and proprietary order routing systems to monitor the protected quotations of trading centers and to properly identify such intermarket sweep orders. The Commission preliminarily does not believe that this category of broker-dealers is very large. The Commission also preliminarily believes it likely that most if not all of these non-trading center broker-dealers that employ their own order-routing technology already have systems in place that monitor best-priced quotations across markets, and thus does not believe that the changes necessary to implement the intermarket sweep order would be substantial.

With respect to maintaining and updating its required written policies and procedures to ensure they continue to be in compliance with the repropoed Rule, for purposes of the PRA the Commission preliminarily estimates that the average annual cost for each trading center would be approximately \$5,676 per trading center per year, for a total annual cost for all trading centers of \$3,456,684.<sup>470</sup> With regard to ongoing monitoring for and enforcement of trading in compliance with the Rule, the Commission preliminarily believes that, once the tools necessary to carry out ongoing monitoring have been put in place (which are included in the above cost estimates), a trading center would be able to incorporate ongoing monitoring and enforcement within the scope of its existing surveillance and enforcement policies and procedures without a substantial additional burden.

The Commission recognizes, however, that this ongoing compliance would not be cost-free, and that trading centers

whose floor they operate to make changes to the exchange's execution systems. Thus, these entities (approximately 160 of the 585) are not directly included within the cost estimates.

<sup>470</sup> See *supra* note 438 and accompanying text.

would incur some additional annual costs associated with ongoing compliance, including compliance costs of reviewing transactions. For instance, the Commission recognizes that access to a database of BBO information for each trading center whose quotations would be protected by the repropoed Trade-Through Rule would be necessary to monitor transactions for compliance with the Rule on an after-the-fact basis. The Commission believes that this information currently is available, at least with respect to the BBO of each trading center, and understands that such information currently is maintained by at least one industry vendor. The Commission preliminarily believes that the cost to each trading center to access this database would be incremental in relation to the cost of other services provided by the vendor.<sup>471</sup> The Commission preliminarily estimates that each trading center would incur an average annual ongoing compliance cost of \$30,144 for a total annual cost of \$18,357,696 for all trading centers.<sup>472</sup>

The Commission also requests comment on whether the Voluntary Depth Alternative could be implemented in a practical and cost-effective manner.<sup>473</sup> To comply, trading centers would need to monitor a significantly larger number of protected quotations displayed by other markets and route orders to execute against such quotations.<sup>474</sup> The Voluntary Depth Alternative, however, would not increase the *number* of orders that a trading center would be required to route to other trading centers if only BBOs were protected. Instead, the *size* of the routed orders would need to be increased to reflect the accumulated depth displayed by other trading centers

<sup>471</sup> The Commission acknowledges that, under the Voluntary Depth Alternative for protected quotations (*see supra* Section II.A.5) if a trading center were to choose to include its depth-of-book quotations in the consolidated quotation system and provide trade-through protection for those orders (to the extent they are automated quotations), it would be necessary for the industry to have access to that depth-of-book information on a real-time and historical basis, and that trading centers may incur additional costs associated with accessing and storing this data. The Commission requests comments on these costs.

<sup>472</sup> This figure was calculated as follows: (16 compliance hours × \$103) + (8 information technology hours × \$67) + (4 legal hours × \$82) × 12 months = \$30,144 per trading center × 609 trading centers = \$18,357,696. See *supra* notes 427 to 429 for notation as to hourly rates.

<sup>473</sup> See *supra* Section II.A.5. for a discussion of the Voluntary Depth Alternative.

<sup>474</sup> See *supra* note 471. As a means to address capacity issues, the SRO participants in the applicable market data Plans potentially could determine to disseminate only those DOB quotations that were within a certain number of price levels away from the NBBO.

in their protected DOB quotations. In addition, the applicable regulatory authorities must be able to monitor and enforce compliance with a rule that protected DOB quotations. At a minimum, this would require an objective and uniform source to identify the quotations that are protected at any particular time.

As noted in section II.A.3 above, any intermarket protection against trade-throughs must be workable and implemented in a way that promotes fair and orderly markets. To the extent commenters are concerned about practical problems with implementing the Trade-Through Rule, would the basis for these concerns be magnified by the Voluntary Depth Proposal? Specifically, comment is requested on all issues relating to the feasibility and desirability of disseminating DOB quotations through Plan processors.<sup>475</sup> For example, would the voluntary dissemination of protected DOB quotations through the Plan processors create a single point of failure that could threaten the stability of trading in NMS stocks?

The Commission also requests comment on the effect that adoption of the Voluntary Depth Alternative would have on competition among markets. One commenter, for example, suggested that protection of DOB quotations might cause increased fragmentation of liquidity across different markets because limit orders, no matter where displayed, would have price protection.<sup>476</sup> Another commenter, in contrast, asserted that protecting only BBOs would lead to greater fragmentation because limit orders would be routed to any market where they would set or equal the BBO and thereby obtain trade-through protection.<sup>477</sup> Comment is requested on the fragmentation issue, as well as in general on whether protecting DOB quotations would inappropriately limit the terms of market competition so as to harm investors and the efficiency of the NMS. For example, would adoption of the Voluntary Depth Alternative inappropriately reduce the scope of competition among markets to the payment of liquidity rebates for

executed limit orders? Comment also is requested on whether adoption of the Voluntary Depth Alternative would generate forces that would lead to a monopolization of trading in a single trading facility.

In assessing the costs of systems changes that may be required by the repropoed Rule, it is important to recognize that much, if not all, of the connectivity among trading centers necessary to implement intermarket price protection has already been put in place. For example, trading centers for exchange-listed securities already are connected through the ITS. The Commission understands that ITS facilities and rules can be modified relatively easily and at low cost to enable an automatic execution functionality. With respect to Nasdaq stocks, connectivity among trading centers already is established through private linkages. Routing out to other trading centers when necessary to obtain the best prices for Nasdaq stocks is an integral part of the business plan of many trading centers, even when not affirmatively required by best execution responsibilities. Moreover, a variety of private vendors currently offer connectivity to NMS trading centers for both exchange-listed and Nasdaq stocks. Many of the broker-dealers that are non-SRO trading centers that would be subject to the Rule already employ smart order routing technology, either their own systems or those of outside vendors, which should limit the cost of implementing systems changes. The Commission also understands that the cost to the Plan processors to incorporate the repropoed Trade-Through Rule and its exceptions would be minimal.

In determining these estimates the Commission also has considered that many market participants are already making changes to their systems to become more competitive. Many of the changes being made would assist the market participants in preparing for implementation of the repropoed Trade-Through Rule. For example, Nasdaq, which previously did not have an order routing system, recently purchased Brut, LLC in order to acquire access to such a system. The Commission preliminarily believes that this acquisition should reduce the costs that would be incurred by Nasdaq to implement the repropoed Trade-Through Rule. The Commission also notes that the NYSE is in the process of modifying its Direct+ System to make more quotations available on an

automated basis.<sup>478</sup> These changes that the NYSE has undertaken should reduce the cost of additional systems changes needed to implement the Trade-Through Rule.

Overall, the Commission preliminarily believes that the repropoed Trade-Through Rule would produce significant benefits that justify the costs of implementation of the Rule.

#### B. Access Rule

Repropoed Rule 610 of Regulation NMS would set forth new standards governing access to quotations in NMS stocks. These standards would prohibit trading centers from imposing unfairly discriminatory terms that would prevent or inhibit the efficient access of any person through members, subscribers, or customers of such trading center, and enable access to NMS quotations through private linkages, rather than mandating a collective intermarket linkage facility. In addition, in order to ensure the fairness and accuracy of displayed quotations, the repropoed Rule would establish an outer limit on the cost of accessing protected quotations of no more than \$0.003 per share (or 0.3% of the quotation price per share for quotations priced less than \$1). Repropoed Rule 610 also would require SROs to establish and enforce rules that would, among other things, prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross the automated quotations of other trading centers. Finally, the repropoed amendment to Rule 301 of Regulation ATS would lower the threshold that triggers the Regulation ATS fair access requirements from 20% to 5% of average daily volume in a security.

##### 1. Benefits

The Commission preliminarily believes that the repropoed Access Rule would help achieve the statutory objectives for the NMS by promoting fair and efficient access to each individual market. By relying on private linkages, rather than mandating a collective intermarket linkage facility, the access provisions of repropoed Rule 610(a) and (b) would allow market centers to connect through flexible and cost effective technologies widely used in the markets today, particularly in the market for Nasdaq stocks. This would allow firms to capitalize on the dramatic improvements in communications and processing technologies in recent years, and thereby enhance the linking of all

<sup>475</sup> The Voluntary Depth Alternative would set up a process through which individual markets could choose to secure protection for their DOB quotations by disseminating them in the consolidated quotation stream. To implement this approach, the SRO participants in the market data Plans would need to establish a mechanism for individual markets to disseminate their quotations through the Plan processor and have them designated as protected quotations. See *supra* Section II.A.5.

<sup>476</sup> Bear Stearns Letter at 2.

<sup>477</sup> Goldman Sachs Letter at 6.

<sup>478</sup> See Securities Exchange Act Release Nos. 50173 (Aug. 10, 2004), 69 FR 50407 (Aug. 16, 2004) and 50667 (Nov. 15, 2004), 69 FR 67980 (Nov. 22, 2004) (SR-NYSE-2004-05).

markets for the future NMS. Private linkages also would provide flexibility to meet the needs of different market participants and allow competitive forces to determine the specific nature and cost of connectivity. The repropoed access provisions of Rule 610(a) and (b) thus would allow market participants to fairly and efficiently route orders to execute against the best quotations for a stock, wherever such quotations are displayed in the NMS. The Commission believes that fair and efficient access to the best quotations of all trading centers is critical to achieving best execution of those orders.

The repropoed access provisions of Rule 610(a) and (b) also would promote fair and efficient access to quotations by prohibiting a trading center from unfairly discriminating against non-members or non-subscribers that attempt to access its quotations through a member or subscriber of such trading center. Such fair access to the quotations of other trading centers is critical for compliance with the repropoed Trade-Through Rule and broker-dealers' duty of best execution.

The repropoed fee limitation of Rule 610(c) would address the potential distortions caused by substantial, disparate fees. As a result of the repropoed fee limitation, displayed prices would more closely reflect actual costs to trade, thereby enhancing the usefulness of market information. The proposed fee limitation also would establish a level playing field across all market participants and trading centers. A single accumulated fee limitation would apply equally to all types of trading centers and all types of market participants, thereby promoting the NMS objective of equal regulation of markets and broker-dealers.

The repropoed fee limitation also should help address the "outlier" business model under which a trading center charges high fees for access to its quotations and passes most of the fees through as rebates to attract liquidity providers. These outliers might attempt to take advantage of intermarket price protection by acting essentially as a toll booth between price levels. Particularly with a trade-through rule, even though high fee markets likely would be the last market to which orders would be routed, prices could not move to the next level until someone routed an order to take out the displayed price at the outlier market. Such a business model would detract from the usefulness of quotation information and impede market efficiency and competition. The repropoed fee cap would preclude the outlier business model. It would place all markets on a

level playing field in terms of the fees they can charge and ultimately the rebates they can pass on to liquidity providers. Some markets might choose to charge lower fees, thereby increasing their ranking in the preferences of order routers. Others might charge the full \$0.003 and rebate a substantial proportion to liquidity providers. Competition would determine which strategy was most successful.<sup>479</sup>

The restrictions on locking or crossing quotations in repropoed Rule 610(d) should promote fair and orderly markets. Locked and crossed markets can cause confusion among investors concerning trading interest in a stock. Restricting the practice of submitting locking or crossing quotations therefore would enhance the usefulness of quotation information. Consistent with the approach to trade-through protection, however, repropoed Rule 610(d) would allow automated quotations to lock or cross manual quotations. Repropoed Rule 610(d) thereby would address the concern that manual quotations may not be fully accessible and recognize that allowing automated quotations to lock or cross manual quotations may provide useful market information regarding the accessibility of quotations. The Commission preliminarily believes, however, that an automated quotation is entitled to protection from locking or crossing quotations. When two market participants are willing to trade at the same quoted price, giving priority to the first-displayed automated quotation should contribute to fair and orderly markets. Moreover, the basic principle underlying the NMS is to promote fair competition among markets, but within a unified system that also promotes interaction between all of the buyers and sellers in a particular NMS stock. Allowing market participants simply to ignore accessible quotations in other markets and routinely display locking and crossing quotations would be inconsistent with this principle. The repropoed restrictions on locking or crossing quotations, in conjunction with the repropoed Trade-Through Rule, should encourage trading against displayed quotations and enhance the depth and liquidity of the markets.

Finally, lowering of the fair access threshold of Rule 301(b)(5) under Regulation ATS<sup>480</sup> from 20% to 5% of average daily trading volume in a security would further strengthen access

to the full range of services of ATSs with significant trading volume in NMS stocks. Such access is particularly important for success of the private linkage approach proposed for access to quotations. The lowering of the fair access threshold also would make its coverage consistent with the existing 5% threshold triggering the order display and execution access requirements of Rule 301(b)(3) of Regulation ATS.<sup>481</sup> As a result, each ATS that is required to disseminate its quotations in the consolidated data stream also would be prohibited from unfairly prohibiting or limiting market participants from becoming a subscriber or customer.

In repropoing Rule 610 and the amendment to Rule 301 of Regulation ATS, the Commission seeks to help ensure that securities transactions can be executed efficiently, at prices established by vigorous and fair competition among market centers. By enabling fair access and transparent pricing among diverse marketplaces within a unified national market, the Commission preliminarily believes that the access proposal would foster efficiency, enhance competition, and contribute to the best execution of orders for NMS securities.

## 2. Costs

The Commission preliminarily believes that repropoed Rule 610 and the repropoed amendments to Rule 301 of Regulation ATS would not impose significant costs on most trading centers and market participants. The system changes necessary to meet the new access standards should be minor. Currently, private linkages are widely used in the equity markets, particularly for trading in Nasdaq stocks.<sup>482</sup> Moreover, the Commission understands that the ITS facilities that currently provide intermarket access for exchange-listed stocks could be modified at minimal cost to provide an auto-execution functionality, at least as an interim measure until private linkages were fully established for exchange-listed stocks.

While commenters were generally supportive of the Commission's proposal to employ private linkages to provide access between markets, some commenters expressed concern that the effort and investment to establish such

<sup>481</sup> 17 CFR 242.301(b)(3).

<sup>482</sup> One commenter, however, felt that the bilateral links required for private linkages would be particularly burdensome to smaller market centers compared to an ITS-type structure. Letter from Donald E. Weeden to Jonathan G. Katz, Secretary, Commission, dated June 30, 2004, at 9-10.

<sup>479</sup> The Commission preliminarily believes that the repropoed fee limitation on protected quotations priced less than \$1.00 would provide the same benefits.

<sup>480</sup> 17 CFR 242.301(b)(5).

connectivity to smaller markets would likely be disproportionate to the liquidity on such a market.<sup>483</sup> Reproposed Rule 610(b)(1), however, would require trading centers that display quotations in the ADF to provide a level and cost of access to their quotations that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities.

Currently, three ATs display quotations in the ADF, two of which also display quotations through the NASDAQ Market Center. Reproposed Rule 610(b) may require these trading centers to incur additional costs to enhance the level of access to their quotations and to lower the cost of connectivity for market participants seeking to access their quotations. The extent to which these trading centers in fact incur additional costs to comply with the proposed access standard would be largely within the control of the trading center itself. ATs and market makers that wish to trade NMS stocks can choose from a number of options for quoting and trading. They can become a member of a national securities exchange and quote and trade through the exchange's trading facilities. They can participate in the NASDAQ Market Center and quote and trade through that facility. Finally, they can quote and trade in the OTC market. The existence of the NASD's ADF makes this third choice possible by providing a facility for displaying quotations and reporting transactions in the consolidated data stream.<sup>484</sup> As a result, the additional connectivity requirements of repropoed Rule 610(b) would be triggered only by a trading center that displays its quotations in the consolidated data stream and chooses not to provide access to those quotations through an SRO trading facility.

Currently, nine SROs operate trading facilities in NMS stocks. Market participants throughout the securities industry generally have established connectivity to these nine points of access to quotations in NMS stocks. By choosing to display quotations in the ADF, a trading center effectively could require the entire industry to establish connectivity to an additional point of access. Potentially, many trading centers could choose to display quotations in the ADF, thereby significantly increasing the overall costs of

connectivity in the NMS. Such an inefficient outcome would become much more likely if an ADF trading center were not required to assume responsibility for the additional costs associated with its decision to display quotations outside of an established SRO trading facility. Consequently, the repropoed access standard in Rule 610(b)(2) would help reduce overall industry costs by more closely aligning the burden of additional connectivity with those entities whose choices have created the need for additional connectivity.

To meet the standard contained in repropoed Rule 610(b)(1), a trading center would be allowed to take advantage of the greatly expanded connectivity options that have been offered by competing access service providers in recent years.<sup>485</sup> These industry access providers have extensive connections to a wide array of market participants through a variety of direct access options and private networks. A trading center potentially could meet the requirement of repropoed Rule 610(b)(1) by establishing connections to and offering access through such vendors. The option of participation in existing market infrastructure and systems should greatly reduce a trading center's cost of compliance.<sup>486</sup>

Several commenters, including some that otherwise supported the proposal, expressed concern that requiring non-discriminatory access to markets might undermine the value of SRO membership.<sup>487</sup> The Commission preliminarily does not believe that adoption of a private linkage approach would seriously undermine the value of membership in SROs that offer valuable services to their members. First, the fact that markets would not be allowed to impose unfairly discriminatory terms on non-members who obtain indirect access to quotations through members does not mean that non-members would obtain *free* access to quotations. Members who provide piggyback access would be providing a useful service and presumably would charge a fee for such

<sup>485</sup> As noted in the Commission's order approving the pilot program for the ADF, the reduction in communications line costs in recent years and the advent of competing access providers offer the potential for multiple competitive means of access to the various trading centers that trade NMS stocks. Securities Exchange Act Release No. 46249, *supra* note 181.

<sup>486</sup> As the self-regulatory authority responsible for the OTC market, the NASD would need to assess the extent to which ADF participants have met the access standards of repropoed Rule 610.

<sup>487</sup> Alliance of Floor Brokers Letter at 10; Amex Letter, Exhibit A at 25–26; BSE Letter at 12; CHX Letter at 14; Citigroup Letter at 12; Phlx Letter at 2; STANY Letter at 9.

service. The fee would be subject to competitive forces and likely would reflect the costs of SRO membership, plus some element of profit to the SRO's members. As a result, non-members that frequently make use of indirect access are likely to contribute indirectly to the costs of the SRO market. Moreover, the unfair discrimination standard of Rule 610(a) would apply only to access to quotations, not to the full panoply of services that markets generally provide only to their members.

The Commission preliminarily does not believe that the proposed fee limitation of repropoed Rule 610(c) would impose significant new costs on most trading centers. A few commenters were concerned about the costs to market participants of administering a fee program under the original proposal, which would have limited trading centers to a fee of \$0.001 and broker-dealers to a fee of \$0.001.<sup>488</sup> The revised proposal, by imposing a single accumulated fee limitation of \$0.003 (when the price of the protected quotation is \$1 or more), would greatly simplify the proposed fee limitation and likely would leave existing fee practices largely intact. Entities that currently charge and collect fees would continue to do so. Market makers likely would collect fees through an SRO trading facility or ECN through which it displayed limit orders or quotations, and the administration of such fee program likely would be handled by the SRO or ECN. Therefore, the revised fee limitation should not impose significant new administrative costs.

The repropoed fee limitation of Rule 610(c) would, however, affect the few markets that currently impose access fees of greater than \$0.003 per share that apply to a wide range of NMS stocks.<sup>489</sup> These markets could be required to re-evaluate their business models in light of the adopted fee limitation. In particular, they likely would need to reduce the rebates they currently pay to liquidity providers. The repropoed limitation also would affect a few trading centers that charge significant access fees for large transactions in specific types of NMS stocks, such as ETFs. It is unlikely, however, that such fees currently generate a large amount of revenues.<sup>490</sup>

The locked and crossed provisions of repropoed Rule 610(d) should not impose significant additional costs for

<sup>488</sup> Brokerage America Letter at 1; Oppenheimer Letter at 2; STANY Letter at 11.

<sup>489</sup> See *supra* note 193 and accompanying text.

<sup>490</sup> The Commission preliminarily believes that the same analysis would apply to the repropoed fee limitation on protected quotations priced less than \$1.00.

<sup>483</sup> See, e.g., Brut Letter at 13; Citigroup Letter at 13; SIA Letter at 16–17; UBS Letter at 9.

<sup>484</sup> Under Rule 301(b)(3) of Regulation ATS, an ATs is required to display its quotations in the consolidated data stream only in those securities for which its trading volume reaches 5% of total trading volume.

the SROs. All SROs currently have rules restricting locking and crossing quotations in exchange-listed stocks to comply with the provisions of the ITS Plan. Such SROs also collect the data and related information required to monitor locked and crossed markets, and the Commission preliminarily believes that the additional surveillance and enforcement costs related to the provisions would be minor. The Commission recognizes, however, that repropoed Rule 610(d), by restricting locked markets with respect to automated quotations, could impose certain trading costs associated with widened spreads if an order that would otherwise have been displayed was not displayed. Although locked markets do occur a certain percentage of the time, they do not occur all the time, and thus, the average spread is between zero and a penny (a penny being the MPV for all but a very few stocks). Thus, the Commission preliminarily believes that any widening of average spreads caused solely by the repropoed rule would be limited to the difference between a sub-penny and penny spread. In addition, a locked market often does not actually represent two market participants willing to buy and sell at the same price because it is likely that the locking market participant is not truly willing to trade at the displayed locking price, but instead chooses to lock rather than execute against the already-displayed quotation to receive a liquidity rebate.

Finally, reducing the fair access thresholds of Regulation ATS would require ATSs that exceed the 5% threshold level to comply with Rule 301(b)(5) under Regulation ATS. Rule 301(b)(5) requires ATSs, among other things, to establish written standards for granting access to trading on its system, to not unreasonably prohibit or limit access to its services, to keep records of all grants or denials of access, and to report such information on Form ATS-R. The Commission preliminarily believes that the costs to meet these requirements are justified by the need to promote fair and efficient access to trading centers with significant volume.

### C. Sub-Penny Rule

Repropoed Rule 612 would prohibit market participants from displaying, ranking, or accepting quotations in NMS stocks that are priced in an increment less than \$0.01, unless the per share price of the quotation is less than \$1.00. It would permit sub-penny quotations below \$1.00, but only to four decimal places.

### 1. Benefits

The Commission believes that the markets' conversion to decimal pricing has benefited investors by, among other things, clarifying and simplifying pricing for investors, making the U.S. securities markets more competitive internationally, and reducing trading costs by narrowing spreads. The Commission is concerned, however, that if the MPV decreases beyond a certain point, some of the benefits of decimals could be lost while some of the negative effects are exacerbated. The Commission preliminarily believes that repropoed Rule 612, which would prohibit an MPV of less than \$0.01 for most NMS stocks, would have several benefits. The majority of the commenters supported the proposal and noted various potential benefits of the proposed rule.<sup>491</sup>

The Commission preliminarily believes that sub-penny quoting impedes transparency by reducing market depth at the NBBO and increasing quote flickering. In an environment where the NBBO can change very quickly, broker-dealers have more difficulty in carrying out their duties of best execution and complying with other regulatory requirements that require them to identify the best bid or offer available at a particular moment (such as the Commission's short sale rule and the NASD's Manning rule).<sup>492</sup>

In addition, the Commission agrees with the many commenters that believed that prohibiting sub-penny quoting would deter the practice of stepping ahead of exposed trading interest by an economically insignificant amount. Limit orders provide liquidity to the market and perform an important price-setting function. The Commission is concerned that, if a quotation or order can lose execution priority because of economically insignificant price improvement from a later-arriving quotation or order, liquidity could diminish and some market participants could incur greater execution costs. As one commenter, the Investment Company Institute, stated, "[t]his potential for the increased stepping-ahead of limit orders would create a significant disincentive for market participants to enter any sizeable volume into the markets and would reduce further the value of displaying limit orders."<sup>493</sup> Improved liquidity should decrease the costs of trading,

especially for large orders.<sup>494</sup> Market participants may be more likely to place limit orders if they know that other market participants cannot quote ahead of them by a sub-penny amount.

### 2. Costs

The Commission recognizes that repropoed Rule 612 would impose certain costs on the U.S. securities markets. Currently, certain NMS stocks are quoted—and in the absence of the rule, others in the future could be quoted—in sub-pennies. For these NMS stocks, quoted spreads would be wider than they otherwise would be, because repropoed Rule 612 would not allow market participants to narrow the spread by a sub-penny amount.

Two commenters stated that investors would suffer harm from artificially widened spreads.<sup>495</sup> Another commenter stated that "the primary result of eliminating subpenny trading would be to preserve a minimum profit for market makers, and would result in significantly worse realized prices for the vast majority of market participants not in the business of making markets."<sup>496</sup> This commenter analyzed trading in six high-volume securities and concluded that proposed Rule 612 would have costs of over \$400 million in these securities alone due to wider spreads.<sup>497</sup> Another commenter stated that, if all markets traded QQQQ solely in sub-pennies, the savings would be approximately \$150 million per year.<sup>498</sup> This commenter, however, did not provide data or analysis showing how it reached this conclusion. No other commenters provided any quantitative analysis of the costs that a sub-penny quoting rule would impose by widening spreads to at least a full penny.

The Commission preliminarily believes that the \$400 million and \$150 million estimates of the cost to the markets caused by wider spreads provided by these two commenters are

<sup>494</sup> One commenter argued that a prohibition on sub-penny quoting should not affect institutional investors' trading costs because improvements in trading technology (such as auto-execution and VWAP trading algorithms) allow them to fill large orders at minimal cost. *See* Tower Research Letter at 9–10. While the Commission agrees that such improvements have been useful, it believes that this commenter does not consider the costs involved in having to develop these technologies in response, at least in part, to insufficient liquidity. Moreover, the Commission believes that this commenter also does not consider the positive externalities that limit orders have on price discovery and price competition; orders that execute without being quoted do not contribute to price discovery and price competition.

<sup>495</sup> *See* Instinet Letter at 51; Mercatus Letter at 9.

<sup>496</sup> Tower Research Letter at 8.

<sup>497</sup> *Id.* at 9.

<sup>498</sup> *See* Instinet Letter at 50.

<sup>491</sup> *See supra* section IV.C.1.

<sup>492</sup> Rule 10a–1 under the Exchange Act, 17 CFR 240.10a–1, and NASD IM–2110–2.

<sup>493</sup> ICI Letter at 20.

inaccurate and excessive. This estimate appears to assume that all trading activity would occur at these narrower quoted spreads. The Commission does not believe that these commenters provided any evidence to substantiate that assumption. Currently, no national securities exchange or national securities association permits quoting in sub-pennies; sub-penny quoting occurs on only a small number of ATSS. Therefore, because spreads on most markets already cannot be smaller than \$0.01, these markets would not be required to take any action in response to repropose Rule 612 that would cause their spreads to widen. Therefore, the cost to these markets of not having sub-penny spreads should not be considered costs of the repropose rule. With respect to the ATSS that currently do permit some NMS stocks to be quoted in sub-pennies, the Commission staff performed a study of trade data in Nasdaq, NYSE, and Amex stocks to better consider commenters' claims. Based on that study, the Commission staff estimates that the costs of widened spreads in these securities would be approximately \$48 million annually (or approximately \$33 million if the Commission were to exempt QQQQ from repropose Rule 612).<sup>499</sup>

In this study, the Commission staff obtained public data from NYSE's "Trade and Quote" files for all NYSE-listed and Amex-listed stocks and public data from the Nasdaq trade file for Nasdaq-listed stocks, for the period June 7–10, 2004. Based on trading activity from the Nasdaq-listed securities, Commission staff estimated that 1.5% of all trades over \$1.00 were reported in a sub-penny increment.<sup>500</sup> These trades accounted for 4.7% of share volume. However, not all trades that were reported as having a sub-penny price resulted from sub-penny quotations. Commission staff excluded VWAP trades which are marked as such in the Nasdaq file.<sup>501</sup> Based on this screened dataset, Commission staff

estimated that 1.4% of trades were reported in sub-penny increments accounting for 2.4% of share volume. Commission staff then calculated the dollar cost if all such trades executed at the near-side penny rather than at a sub-penny amount. This price difference, multiplied by the executed volume, produces a dollar cost per trade.<sup>502</sup> Summed across all sub-penny trades, the average daily cost for this sample was \$80,973. At 252 trading days per year, this results in \$20,400,235 on an annual basis.

Commission staff performed a similar analysis on the trade data for Amex-listed stocks, except that the data set did not permit VWAP trades to be excluded.<sup>503</sup> On an annualized basis, Commission staff estimated that the gross cost resulting from slightly wider spreads would be \$16 million (or only \$1.2 million if QQQQ is excluded). Similarly, the Commission staff estimated that the gross costs from wider spreads would be approximately \$12 million annually for NYSE-listed stocks.

Another potential cost of repropose Rule 612 is that market participants that have developed systems that allow their users to quote in sub-pennies would, for most NMS stocks, lose the ability to gain any market advantage from such enhancements. In addition, any market participant that currently allows its users to display, rank, or accept orders or quotations in sub-pennies would incur costs in reprogramming its systems to prevent the entry of sub-penny orders or quotations. The Commission preliminarily believes, however, that these costs would be negligible. Currently, the exchanges and Nasdaq do not permit sub-penny quoting; only two major ECNs permit sub-penny quoting, but only in a limited number of securities.<sup>504</sup> These ECNs would have to take only minor steps to readjust their systems to comply with repropose Rule 612. Finally, the Commission preliminarily believes that paragraph (b) of repropose Rule 612, which would prohibit quotations below \$1.00 from extending beyond four

decimal places, would have negligible systems costs. The Commission currently is not aware of any market that quotes and trades NMS stocks in increments beyond four decimal places and preliminarily believes, therefore, that no market would incur systems costs to limit quotations below \$1.00 to a maximum of four decimal places.

After carefully considering all the comments received, the Commission preliminarily believes that, on balance, the benefits of repropose Rule 612 would justify the costs.

#### D. Market Data Rules and Plan Amendments

The Commission is repropose amendments to the rules relating to the dissemination of market information to the public. In particular, the Commission is repropose amendments to the Plans<sup>505</sup> to modify the current formulas for allocating market data revenues to the SROs, and to require the establishment of non-voting advisory committees comprised of interested parties other than SROs. In addition, the Commission is repropose to rescind the current prohibition in Exchange Act Rule 11Aa3–1 (proposed to be redesignated as Rule 601) on SROs and their members from independently distributing their own trade reports, and is repropose an amendment to Exchange Act Rule 11Ac1–2 (proposed to be redesignated as Rule 603) to incorporate uniform standards pursuant to which they may independently distribute their own trade reports and quotations (outside of providing the requisite information to Plan processors). The Commission is further repropose to amend Exchange Act Rule 11Ac1–2 (proposed to be redesignated as Rule 603) to make explicit that all SROs must act jointly through the Plans and through a single processor per security to disseminate consolidated market information in NMS stocks to the public. Finally, the Commission is repropose amendments to Exchange Act Rule 11Ac1–2 (proposed to be redesignated as Rule 603) to streamline and simplify the consolidated display requirements by reducing the data required to be displayed under the rule, and by limiting the range of the rule to the display of such data in trading and order-routing contexts.

#### 1. Revenue Allocation Formula

a. Benefits. The Commission preliminarily believes that the repropose amendment to the Plans

<sup>499</sup> See Memorandum from the Office of Economic Analysis, Commission, to File, dated December 15, 2004. This study is available on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed/s71005.shtml>) and from the Commission's Public Reference Room.

<sup>500</sup> Trades below \$1.00 were excluded from the sample as Rule 612 would not prohibit sub-penny quotations priced less than \$1.00.

<sup>501</sup> Executions occurring at a sub-penny price resulting from a mid-point, VWAP, or similar volume-weighted pricing algorithm would not be prohibited by repropose Rule 612. For purposes of this study, Commission staff excluded all other trades that have a condition code other than "regular way" (e.g., trades reported after normal trading hours, bunched trades, next-day trades, previous reference price trades, and late trade reports).

<sup>502</sup> For example, the cost to a sub-penny trade at price \$25.248 for 300 shares is as follows. The assumption is that, without sub-penny quotations, this trade would have occurred at \$25.25—a difference of \$0.002 per share. At 300 shares, this trades incurs a cost of \$0.60 (\$0.002 x 300). A sub-penny trade at \$25.242 would incur a cost of \$0.002 per share under the assumption that, under Rule 612, it would execute at \$25.24.

<sup>503</sup> See *supra* note 499.

<sup>504</sup> As of December 6, 2004, one of these ECNs (Brut) permitted sub-penny quoting only in securities priced below \$5.00; the other ECN (Inet) permitted sub-penny quoting for securities priced below \$1.00 and also for four other securities (QQQQ, SMH, JDSU, and SIRI).

<sup>505</sup> See *supra* note 21 and accompanying text.

modifying the current formulas for allocating market data revenues would be beneficial to the marketplace because the new allocation formula would allocate revenues to markets based on the value of their quotations in addition to their trades. The current formulas allocate Plan revenues based solely on the number or share volume of an SRO's reported trades, and do not allocate revenues to those market centers that generate quotations with the best prices and the largest sizes that are an important source of public price discovery. The new allocation formula also should help to reduce the economic and regulatory distortions caused by the current formulas, including wash sales, trade shredding, and SRO print facilities.<sup>506</sup> Because the repropoed formula would address these distortive practices and would allocate revenues to those market centers that provide the most useful market information, the Commission preliminarily believes that the NMS would be benefited as a whole.

The repropoed new revenue allocation formula would encompass a two-step process. Under the proposed initial step, the "Security Income Allocation," a Network's distributable revenues would be allocated among the individual securities included in the Network's data stream based on the square root of the dollar volume of trading in each security. Use of the square root function is appropriate to take into account the level of trading activity in each security, while adjusting for the disproportionate level of trading in the most active NMS stocks when distributing revenues among the various securities.

Following this initial distribution of revenues, the next step in the process would be to allocate the revenues distributed to an individual security among the various SROs that trade the security based on each SRO's trading and quoting activity. Specifically, under the repropoed "Trading Share" criterion, fifty percent of the revenues allocated to a particular security (subject to a \$2 cap per qualified transaction report) would be allocated to SROs based on their proportion of the total dollar volume and number of qualified trades (transactions that have a dollar volume of \$5,000 or greater) in that security. A few commenters stated that small trades (transactions that have a dollar value of less than \$5000) should be entitled to partial credit under this criterion because these trades also contribute to public price discovery.<sup>507</sup>

<sup>506</sup> See Proposing Release, 69 FR at 11179–11180.

<sup>507</sup> See, e.g., BSE Letter at 16; CHX Letter at 19–20; E\*TRADE Letter at 11.

The Commission acknowledges the benefits of small trades and has amended the original proposed new formula to provide for a proportional allocation of revenues for such trades. The repropoed Trading Share measure is intended to allocate revenue to those SROs that actively trade in the security, thereby providing liquidity and price discovery, while reducing the potential for the shredding of trade volume.

Under the repropoed "Quoting Share" criterion, fifty percent of the revenues allocated to a particular security under the Security Income Allocation measure would be allocated to SROs based on their proportion of credits earned for the time and size of their quotations at the NBBO in that security during regular trading hours. Many commenters agreed with the Commission that, if the Networks were to continue allocating revenues to the SROs, the current allocation formulas needed to be updated.<sup>508</sup> In particular, some of these commenters noted the benefits of adding a quoting component to the new formula,<sup>509</sup> especially if revenues are allocated only for automated and accessible quotations. Some commenters, however, were concerned that the inclusion of quotations in the proposed new allocation formula could lead new types of "gaming" of the formula, such as flashing quotations with no real intention to trade at those prices simply to earn more quote credits—and thereby more revenues—under the Quoting Share measure.<sup>510</sup> The Commission preliminarily believes that the proposed requirement that quotations last at least one second to earn credits coupled with overall market discipline imposed by current order-routing practices discouraging "low-cost" quotations at the NBBO should minimize the potential for such gaming behavior. The Quoting Share criterion of the repropoed formula is intended to do what the current formulas do not—allocate revenue to those markets whose quotations frequently equal the best prices and for the largest sizes.

The Commission received a number of comments regarding the potential cost and complexity of the proposed

<sup>508</sup> See, e.g., Amex Letter at 11; ATD Letter at 4; Bloomberg Tradebook Letter at 7; BSE Letter at 15; ICI Letter at 21; Morgan Stanley Letter at 22; Nasdaq Letter II at 31; NYSE Letter, Attachment at 11–12; STA Letter at 7; UBS Letter 10; Vanguard Letter at 6.

<sup>509</sup> See, e.g., Amex Letter at 11; ATD Letter at 4; Bloomberg Tradebook Letter at 7–8; Morgan Stanley Letter at 22–23; NYSE Letter, Attachment at 11; STA Letter at 7; Vanguard Letter at 6.

<sup>510</sup> See, e.g., ArcaEx Letter at 13; Brut Letter at 22; CHX Letter at 19; Instinet Letter at 41.

revenue allocation formula.<sup>511</sup> The Commission notes that, consistent with the approach of the repropoed Trade-Through Rule and the repropoed Access Rule, it has determined to eliminate from the repropoed formula the most complex elements of the proposed allocation formula that were intended primarily to address the problem of manual quotation—the "NBBO Improvement Share" criterion and the automatic cut-off for manual quotations left at the NBBO under the Quoting Share criterion. Because the revised formula would only allocate revenues for automated quotations, and manual quotations would be excluded from the any revenue allocation, the Commission believes that it is no longer necessary to include an NBBO Improvement Share criterion and automatic cut-off for manual quotations in the proposed new formula. As a result, the repropoed formula is substantially less complex than originally proposed.

In sum, the Commission preliminarily believes that the greatest benefit of allocating Plan revenues to the SROs based equally on the proposed Trading Share and Quoting Share measures is that such measures would allocate revenues to an SRO for its overall contribution of both quotations and trades, while reducing the incentive for distortive trade reporting practices caused by the current formulas. Investors would benefit from the proposed new formula because these broad-based measures would allocate revenues to those SROs that provide investors with the most useful market information, and thus that contribute to public price discovery, by allocating them a larger portion of Plan revenues.

b. Costs. The Commission recognizes that the current allocation formulas have been used since the creation of the Plans and Networks in the 1970s, and that the SROs and the Network processors have become familiar with those formulas for purposes of allocating revenues and structuring their businesses. Because the repropoed new allocation formula is more detailed than the current formulas, the Network processors would have to learn the particular features of the new formula and would have to consider SRO quotations in addition to reported trades as a measure for allocating Plan revenues. Accordingly, the Network processors, or some other entity retained by the Networks, would be required to

<sup>511</sup> See, e.g., Angel Letter I at 11; BSE Letter at 15, 18; Brut Letter at 22–23; Callcott Letter at 4; CBOE Letter at 2, 9; Instinet Letter at 42; ISE Letter at 9; Nasdaq Letter II at 31; NSX Letter at 7; NYSE Letter, Attachment at 11; Phlx Letter at 3–4.

develop a program to calculate the Trading Shares and Quoting Shares of the SRO participants. All of the data necessary for implementation of the formula would be disseminated through the consolidated data stream on a real-time basis. If a single entity were retained to handle the task for all three Networks, the Commission estimates that it would cost approximately \$1 million annually to make the requisite calculations under the proposed new formula and to disseminate the results to the SRO participants on a daily basis. This estimated cost of implementation and compliance represents only 1/4 of one percent of the total revenues collected and distributed through the Plans for 2003.

In addition, some SROs are likely to be allocated a smaller portion of Plan revenues under the repropounded new allocation formula than they would have received under the existing formulas, while other SROs would receive a larger portion of revenues. This would result if certain SROs are currently reporting a large number of trades or share volume of trades, but are not necessarily providing the best quotations or trades with larger sizes. A few commenters expressed concern that certain business models would be adversely impacted by the proposed new allocation formula,<sup>512</sup> particularly for those markets that primarily handle small retail order flow.<sup>513</sup> The Commission recognizes that reforming formulas that have remained unchanged for many years may affect the competitive position of various markets. Given the severe deficiencies of these formulas, however, it does not believe that the interests of any particular business model should preclude updating the formulas to reflect current market conditions. The repropounded formula is designed to reflect more appropriately the contributions of the various SROs to the consolidated data stream and thereby better align the interests of individual markets with the interests of investors. The Commission therefore preliminarily believes that the benefits of the proposed new allocation formula justify the costs of implementation.

<sup>512</sup> See, e.g., Brut Letter at 22; BSE Letter at 16; CHX Letter at 19, 21–22; E\*TRADE Letter at 11; NSX Letter at 6–7.

<sup>513</sup> See, e.g., BSE Letter at 16; CHX Letter at 19, 21–22; E\*TRADE Letter at 11. The Commission is proposing a provision in the new formula that would provide a partial allocation of revenues for smaller trades that have a dollar value of less than \$5,000. This provision should lessen impact of the modified formula on exchanges that handle small retail orders.

## 2. Plan Governance

a. Benefits. The Commission preliminarily believes that the repropounded amendment to the Plans requiring the creation of advisory committees would improve Plan governance. Under the Plans, a representative of each SRO participating in the Plan is a member of the operating committee that governs that Plan. The repropounded amendment to the Plans would require the establishment of non-voting advisory committees comprised solely of persons not employed by or affiliated with an SRO participant. This reproposal is intended to broaden participation in the governance of the Plans.

The proposed amendment would require the SRO participants to select the members of the advisory committee comprised, at a minimum, of one or more representatives associated with (1) A broker-dealer with a substantial retail investor base, (2) a broker-dealer with a substantial institutional investor customer base, (3) an ATS, (4) a data vendor, and (5) an investor. In addition, each SRO participant would be entitled to select an additional committee member. The Commission believes that the composition of the advisory committee would give interested parties other than the SROs a voice in matters that affect them.

The members of the advisory committee would have the right to submit their views to the operating committee on Plan business (other than matters determined to be confidential by a majority of Plan participants), prior to any decision made by the operating committee, and would have the right to attend operating committee meetings. Broader participation in the Plans through the creation of Plan advisory committees would be beneficial to the administration of the Plans because it would provide transparency to the Plan governance process and could promote the formation of industry consensus on disputed issues.

b. Costs. The repropounded amendment to the Plans requiring the formation of advisory committees could potentially result in costs to the SRO participants who would be required to engage in a selection process for purposes of establishing such committees. A Plan's operating committee as a whole would be required to select a minimum of five committee members, while each SRO participant also would have the right to select an additional committee member. This selection process could potentially result in added costs and administrative burden and expense to the SRO participants.

The repropounded Plan amendment also could potentially disrupt the current governance of the Plans by their participants. Since the creation of the Plans, representatives from the SROs have been the sole participants in the Plans and have been responsible for their administration. A few commenters believed that the additional participation of non-SRO parties could potentially increase the difficulty of reaching a consensus on Plan business, stating that too many members on an advisory committee could complicate and disrupt, rather than assist, Plan operations due to differing agendas.<sup>514</sup> Although such a result may occur at times, the Commission preliminarily believes that this cost would be justified by the benefits that could be gained by increasing the transparency of Plan operations and giving parties other than SROs an opportunity to submit their views. In the past, the Plans may not have adequately considered the viewpoints of non-SRO parties on important issues such as fees and administrative burdens. Establishing advisory committees would address this problem and thereby potentially make the Plans more responsive to the needs of market participants and investors.

## 3. Proposed Amendments to Rules 11Aa3–1 and 11Ac1–2 (Proposed to Be Redesignated as Rules 601 and 603)

### a. Independent Distribution of Information.

i. Benefits. The Commission is repropounding an amendment to Exchange Act Rule 11Aa3–1 (proposed to be redesignated as Rule 601) that would rescind the prohibition on SROs and their members from disseminating their trade reports independently.<sup>515</sup> Under the repropounded amendment to Exchange Act Rule 11Aa3–1 (proposed to be redesignated as Rule 601), members of an SRO would continue to be required to transmit their trades to the SRO (and SROs would continue to transmit trades to the Networks pursuant to the Plans), but such members also would be free to distribute their own data independently, with or without fees. The Commission preliminarily believes that independently distributed information could be beneficial to investors and other information users because depth-

<sup>514</sup> See, e.g., Amex Letter, Exhibit A at 21–22; ISE Letter at 10; Reuters Letter at 3.

<sup>515</sup> Proposed Regulation NMS would remove the definitions in paragraph (a) of Exchange Act Rule 11Aa3–1 (proposed to be redesignated as Rule 601) and place them in proposed Rule 600. Subparagraphs (c)(2) and (c)(3) of Exchange Act Rule 11Aa3–1 (proposed to be redesignated as Rule 601) would be rescinded. As a result, subparagraph (c)(4) of Exchange Act Rule 11Aa3–1 would be redesignated as subparagraph (b)(2) of Rule 601.



of-book quotations have become increasingly important as decimal trading has spread displayed depth across a greater number of price points.

Reproposed Rule 603(a) would establish uniform standards for distribution of both quotations and trades. The repropoed standards would require an exclusive processor, or a broker or dealer with respect to information for which it is the exclusive source, that distributes quotation and transaction information in an NMS stock to a securities information processor ("SIP") to do so on terms that are fair and reasonable. In addition, those SROs, brokers, or dealers that distribute such information to a SIP, broker, dealer, or other persons would be required to do so on terms that are not unreasonably discriminatory. Furthermore, these uniform standards would be based, in part, on similar requirements found in Sections 3 and 11A of the Exchange Act<sup>516</sup> for SROs and entities that distribute SRO information on an exclusive basis. The Commission preliminarily believes that extending these requirements to non-SRO market centers, including ATSS and market makers, would help assure equal regulation of all markets that trade NMS stocks.

ii. Costs. The Commission recognizes that the rescission of the prohibition on independent distribution of trade reports under Rule 11Aa3-1 (proposed to be redesignated as Rule 601) could potentially lead to market centers incurring costs associated with the independent distribution of their market data if they choose to distribute such data without charging a fee. In addition, investors may have to pay for additional data if market centers choose to charge a fee for the additional data. Furthermore, a corollary to one commenter's assertion that market centers could benefit from additional revenues if market centers choose to distribute their own quotation information<sup>517</sup> is that the data from one or more other market centers could potentially become more or less valuable than another market center's data, and thereby increase or reduce that market center's overall income. The Commission preliminarily does not believe that there will be any costs associated with the requirement to establish uniform standards for the distribution of trades and quotations pursuant to repropoed Rule 603(a), but requests comment on this issue.

#### b. Consolidation of Information.

i. Benefits. All SROs currently participate in Plans that provide for the dissemination of consolidated information for the NMS stocks that they trade. Repropoed Rule 603(b) would confirm by Exchange Act rule that both existing and any new SROs would be required to continue to participate in joint-industry plans to disseminate consolidated information in NMS stocks to the public. This repropoed amendment would provide the benefit of clarifying that all SROs—whether existing or new—would be required to participate jointly in one or more Plans to disseminate consolidated information in NMS stocks. The repropoed amendment also would require that all quotation and trade information for an individual NMS stock be disseminated through a single processor (currently, SIAC or Nasdaq). The Commission preliminarily believes that requiring a single processor for a particular security would help to ensure that investors continue to receive the benefits of obtaining consolidated information from a single source.

ii. Costs. Given that consolidated market information currently is disseminated through a single processor per stock, the Commission does not foresee any new costs associated with repropoed Rule 603(b).

#### c. Display of Consolidated Information.

i. Benefits. Repropoed Rule 603(c) (currently Exchange Act Rule 11Ac1-2) would substantially revise the consolidated display requirement by limiting its scope. It would incorporate a new definition of "consolidated display" (set forth in repropoed Rule 600(b)(13)) that is limited to the prices, sizes, and market center identifications of the NBBO, along with the "consolidated last sale information" (which is defined in proposed Rule 600(b)(14)). Beyond disclosure of this basic information, market forces, rather than regulatory requirements, would be allowed to determine what, if any, additional data from other market centers is displayed. In particular, investors and other information users ultimately would be able to decide whether they need additional information in their displays.

Repropoed Rule 603(c) also would eliminate the burden on vendors and broker-dealers to display a complete montage of quotations from all market centers trading a particular security, which would include the price of quotations that may be far away from the current NBBO. Furthermore, vendors and broker-dealers would have the ability to decide what, if any, additional data from other market

centers beyond this basic disclosure to display. Vendors, broker-dealers, and investors would benefit from this reduced consolidated display requirement through a more efficient use of system capacity and because the costs of obtaining necessary data could be lowered. The Commission believes that giving investors the ability to choose (and pay for) only the data they need and use would be beneficial.

Repropoed Rule 603(c) would narrow the contexts in which a consolidated display is required to those when it is most needed—a context in which a trading or order-routing decision could be implemented. For example, the consolidated display requirement would continue to cover broker-dealers who provide on-line data to their customers in software programs from which trading decisions can be implemented. Similarly, the requirement would continue to apply to vendors who provide displays that facilitate order routing by broker-dealers. It would not apply, however, when market data is provided on a purely informational website that does not offer any trading or order-routing capability. Repropoed Rule 603(c) also would simplify the rule language to require that consolidated data be made available in an equivalent manner as other data and would rescind unnecessary provisions in order to update the Rule.<sup>518</sup> Repropoed Rule 603(c) should benefit broker-dealers and vendors by making compliance with the repropoed Rule's more tailored requirements easier and more efficient.

ii. Costs. A potential cost attributable to repropoed Rule 603(c) could be that there currently may be individuals who use the displayed montage of quotations from all market centers trading a particular security. If vendors and broker-dealers determined not to display this additional information, these investors would be required to obtain the additional data at additional cost. Repropoed Rule 603(c) also could potentially result in an administrative cost or burden for vendors and broker-dealers that would be required to assess in what circumstances they are displaying market data information for trading and order-routing purposes and in what circumstances they are displaying such information for other purposes. The Commission preliminarily believes that such a cost would be minimal.

<sup>518</sup> The provisions proposed to be rescinded include requirements relating to moving tickers, categories of market information, and representative bids and offers.

<sup>516</sup> 15 U.S.C. 78c and 15 U.S.C. 78k-1.

<sup>517</sup> Specialist Assoc. Letter at 16-17.

### E. Regulation NMS

The Commission is repropounding to redesignate the current NMS rules adopted under Section 11A of the Exchange Act<sup>519</sup> as Regulation NMS, make non-substantive conforming changes to various rules, and create a separate definitional rule, Rule 600, which would contain all of the defined terms used in Regulation NMS. Currently, each NMS rule includes its own set of definitions, and some identical terms, such as “covered security,” “reported security,” and “subject security,” are defined inconsistently. Although repropounded Rule 600 would retain, unchanged, most of the definitions used in the existing NMS rules, it would delete or revise obsolete definitions and eliminate the use of inconsistent definitions for identical terms. Repropounded Rule 600 would not alter the requirements or operation of the existing NMS rules.

#### 1. Benefits

The Commission believes that repropounded Rule 600 and the related proposed amendments to various rules would benefit all entities that are and would be subject to the requirements of the rules contained in Regulation NMS, including broker-dealers, national securities exchanges, the NASD, ECNs, SIPS, and vendors. By eliminating or revising obsolete and inconsistent definitions and adopting a single set of definitions that would be used throughout Regulation NMS, repropounded Rule 600 should make Regulation NMS clearer and easier to understand, thereby facilitating compliance with its requirements and potentially easing the compliance burden on entities subject to Regulation NMS. Increased compliance with Regulation NMS would, in turn, benefit investors and the public interest. Similarly, the related non-substantive amendments to various rules would ensure that those rules use the definitions provided in repropounded Rule 600 and refer accurately to the redesignated NMS rules.

#### 2. Costs

Repropounded Rule 600 would update and clarify the definitions used in existing NMS rules. Neither repropounded Rule 600 nor the related conforming proposed amendments to various rules would alter the existing requirements of the NMS rules or other Commission rules. Accordingly, the Commission believes that repropounded Rule 600 and the related amendments would impose few additional costs on entities subject to Regulation NMS. Although some

additional personnel costs may be incurred in reviewing the changes, the Commission believes that these costs would be minimal.

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

Section 3(f) of the Exchange Act<sup>520</sup> requires the Commission, when engaging in rulemaking that requires the Commission to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition and capital formation. Section 23(a) of the Exchange Act<sup>521</sup> requires the Commission to consider whether the action will promote efficiency, competition and capital formation. Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>522</sup> To assist the Commission in evaluating the costs and benefits of Regulation NMS, the Commission solicited comment in the Proposing Release on whether any of the proposals discussed therein would have an adverse effect on competition that is neither necessary nor appropriate in furtherance of the purposes of the Exchange Act, and whether they would, if adopted, promote efficiency, competition and capital formation. The Commission also requested commenters to provide empirical data and other factual support for their views on these subjects. The Commission has considered comments received and has repropounded these rules, taking into account these comments. The Commission requests comment on these issues in the context of the repropounded rules.

#### A. Trade-Through Rule

The Commission preliminarily believes that the price protection that would be provided by the repropounded Trade-Through Rule would encourage the use of limit orders and aggressive quoting, which should help improve the price discovery process, and contribute to increased liquidity and depth in the markets. The greater the number of limit orders available at better prices and greater size, the more liquidity available to fill incoming marketable orders. Thus, greater depth and liquidity should lead to improved execution quality,

particularly for larger-sized institutional orders. The Commission also preliminarily believes that the repropounded Trade-Through Rule, by providing intermarket price protection for accessible, automated orders and not requiring automated markets to wait for responses from non-automated markets, would help promote efficiency in the markets by more effectively linking markets together and integrating trading centers with different market structures into the NMS, and by providing an incentive for non-automated markets to automate. Repropounded Rule 611 also should promote investor confidence in the markets by helping to ensure that customer orders are executed at the best price available and providing protection against limit orders being bypassed by inferior priced executions. Comment is requested on whether extending trade-through protection to DOB quotations would significantly increase the benefits of the repropounded Trade-Through Rule. Would protecting quotations at multiple price levels further encourage the display of limit orders and thereby significantly enhance depth and liquidity in the NMS?

The Commission recognizes the vital importance of preserving competition among market centers,<sup>523</sup> and preliminarily believes that repropounded Rule 611 would promote intermarket competition by leveling the playing field between automated and non-automated markets and, to the extent that the existing trade-through rule serves to constrain competition, by removing this barrier to competition. In addition, the Commission preliminarily believes that market participants and intermediaries, consistent with their desire to achieve the best price and their duty of best execution, would continue to rank trading centers according to the total range of services provided by such markets. The most competitive—*i.e.* attractive—trading center would be the first choice for routing marketable orders, thereby enhancing the likelihood of execution for limit orders routed to that trading center. Because likelihood of execution is very important to limit orders, routers of limit orders likely would be attracted to this preferred trading center. More limit orders would enhance the depth and liquidity at the preferred trading center, thereby increasing its attractiveness for marketable orders, and beginning the cycle over again.

<sup>523</sup> Many commenters believed that an opt-out exception was necessary to promote competition among trading centers, particularly competition based on factors other than price, such as speed of response. See *supra* Section II.A.4.a.

<sup>519</sup> 15 U.S.C. 78k-1.

<sup>520</sup> 15 U.S.C. 78c(f).

<sup>521</sup> 15 U.S.C. 78w(a).

<sup>522</sup> 15 U.S.C. 78w(a)(2).

Trading centers that offer poor services, such as slow response times, would likely rank near the bottom in order-routing preferences of market participants and intermediaries. Whenever a least-preferred trading center is merely posting the same price as other trading centers, orders would be routed to the other, more preferred, trading centers. Competitive forces would continue to dictate that the lowest ranked trading center in order-routing preference would suffer from offering a poor range of services to the routers of marketable orders. The Commission therefore preliminarily does not believe that repropoed Rule 611 would eliminate competition among markets.

The Commission requests comment on the effect that adoption of the Voluntary Depth Alternative would have on competition among markets. One commenter, for example, suggested that protection of DOB quotations might cause increased fragmentation of liquidity across different markets because limit orders, no matter where displayed, would have price protection.<sup>524</sup> Another commenter, in contrast, asserted that protecting only BBOs would lead to greater fragmentation because limit orders would be routed to any market where they would set or equal the BBO and thereby obtain trade-through protection.<sup>525</sup> Comment is requested on the fragmentation issue, as well as in general on whether protecting DOB quotations would inappropriately limit the terms of market competition so as to harm investors and the efficiency of the NMS. For example, would adoption of the Voluntary Depth Alternative inappropriately reduce the scope of competition among markets to the payment of liquidity rebates for executed limit orders? Comment also is requested on whether adoption of the Voluntary Depth Alternative would generate forces that would lead to a monopolization of trading in a single trading facility.

The end result should be an NMS that more fully meets the needs of a wide spectrum of investors, particularly long-term investors and publicly traded companies, by providing increased efficiency and improved depth and liquidity to our capital markets. By providing increased efficiency and promoting investor confidence in quality executions, investors may be more willing to invest in our capital markets, thus promoting the ability of

listed companies to raise capital at lower cost.

#### B. Access Rule

Repropoed Rule 610 would establish standards governing access to quotations in NMS stocks that (1) prohibit trading centers from unfairly discriminating against non-members members or non-subscribers that attempt to access quotations through a member or subscriber of the trading center, and enable access to NMS quotations through private linkages, (2) establish an outer limit on the cost of accessing such quotations of no more than \$0.003 per share, and (3) require SROs to establish and enforce rules that, among other things, prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross the automated quotations of other trading centers. The repropoed amendment to Rule 301(b)(5) under Regulation ATS would lower the threshold that triggers the Regulation ATS fair access requirements from 20% to 5% of average daily volume in a security.

The repropoed access provisions are intended to bolster investor confidence in the markets by helping to ensure investors that their orders will be executed at the best prices and will not be subject to hidden fees, regardless of the market on which the execution takes place. By generally imposing a uniform fee limitation of \$0.003 per share, the proposed rules would promote equal regulation of different types of trading centers, where currently some are permitted to charge fees and some are not, thereby leveling the playing field among diverse market centers. Moreover, the Commission preliminarily believes that, by prohibiting a trading center from imposing unfairly discriminatory terms that would prevent or inhibit the efficient access of any person through members, subscribers, or customers of such trading center, the repropoed rule would promote competition among trading centers.

The Commission preliminarily believes that repropoed Rule 610 also would increase transparency and efficiency in the market, thereby enhancing investor confidence, and thus capital formation. Specifically, the repropoed Rule would permit private linkages between markets, rather than mandating a collective intermarket linkage facility. Private linkages would permit market centers to connect through cost effective and technologically advanced communications networks. Such systems are widely utilized in the

market for Nasdaq stocks today and should provide speed and flexibility to trading centers and their market participants. The use of private linkages should encourage interaction between the markets and reduce fragmentation by removing impediments to the execution of orders between and among marketplaces, thereby increasing efficiency and competition.

Several commenters expressed concerns regarding the impact that the access fee proposal could have on competition.<sup>526</sup> As discussed in detail in Section III, the Commission preliminarily believes that the flat limitation on access fees of \$0.003 per share would be the fairest and most appropriate solution to what has been a longstanding and contentious issue. A single accumulated fee cap would apply equally to all types of trading centers and all types of market participants, thereby promoting the NMS objective of equal regulation of markets and broker-dealers.<sup>527</sup> The \$0.003 fee limitation would be consistent with current business practices, as very few trading centers charge fees that exceed this amount.<sup>528</sup> In addition, a fee limitation is necessary to preclude individual trading centers from raising their fees substantially in an attempt to take improper advantage of strengthened protection against trade-throughs and the adoption of a private linkage regime.

In addition, the repropoed rule is designed to reduce the instances of locked and crossed quotations, which should promote capital formation by providing market participants a clear picture of the true trading interest in a stock. Moreover, the Commission preliminarily believes that the repropoed access provisions would encourage interaction between the markets and reduce fragmentation by removing impediments to the execution of orders between and among marketplaces, thereby increasing efficiency and competition. Finally, the Commission preliminarily believes that the repropoed access rule would assist broker-dealers in evaluating and complying with their best execution obligations.

<sup>526</sup> See, e.g., Amex Letter, Exhibit A at 23-24; Bloomberg Summary of Intended Testimony at 3; BrokerageAmerica Letter at 1; Brut Letter at 14; CHX Letter at 15; Domestic Securities Summary of Intended Testimony; Instinet Letter at 28, 33-34; TrackECN Letter at 3.

<sup>527</sup> Section 11A(c)(1)(F) of the Exchange Act.

<sup>528</sup> Cf. Instinet Letter at 35 ("there is no basis for adopting any limitation other than at the prevailing \$0.003 per share level, which was arrived at through open competition among ATSS, ECNs, and SRO markets in the Nasdaq market").

<sup>524</sup> Bear Stearns Letter at 2.

<sup>525</sup> Goldman Sachs Letter at 6.

### C. Sub-Penny Rule

The Commission has considered repropounded Rule 612 in light of Sections 3(f) and 23(a)(2) of the Exchange Act and preliminarily believes that the rule would not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. To the contrary, by preserving the benefits of decimalization and guarding against the less desirable effects of further reducing the MPV, repropounded Rule 612 should promote fair and vigorous competition. The Commission acknowledges that the Rule would, in some circumstances, prevent market participants from offering marginally better prices. Some commenters argued that a prohibition on quoting in sub-pennies, at least in some NMS stocks, would inhibit price competition and artificially widen spreads.<sup>529</sup> Nevertheless, the Commission is concerned that sub-penny quoting may be used by market participants more as a means of stepping ahead of competing limit orders for an economically insignificant amount than of promoting genuine price competition.

The Commission preliminarily believes that the repropounded Rule would assist broker-dealers in evaluating and complying with their best execution obligations, as well as other rules premised on identifying the price of a security at a particular moment in time. The Commission also preliminarily believes that the repropounded Rule would enhance depth and transparency by preventing trading interest from being spread across an increasing number of price points. It also would prevent market participants from gaining priority over a standing limit order without making an economically significant contribution to the price of a security. In these respects, the repropounded Rule would encourage market participants to use limit orders, an important source of liquidity. Accordingly, the repropounded Rule may promote market efficiency, competition, and capital formation. In addition, the repropounded Rule also would bolster investor confidence by ensuring that their orders, especially large orders, can be executed without incurring large transaction costs. This increase in investor confidence should also promote market efficiency, competition, and capital formation.

The Commission believes that the repropounded Rule would establish common quoting conventions that would increase transparency in the

markets. Moreover, the Commission preliminarily believes that the repropounded Rule would encourage interaction between the markets and reduce fragmentation by removing impediments to the execution of orders between and among markets. The increased transparency in the markets and reduction of fragmentation between the markets may bolster investor confidence, thereby promoting capital formation.

### D. Market Data Rules and Plan Amendments

The Commission preliminarily believes that the repropounded Plan amendment modifying the current revenue allocation formulas would promote efficiency and competition in the marketplace by eliminating incentives for market participants to engage in distortive trading practices such as wash trades, trade shredding, and SRO print facilities to obtain market data revenues. Similarly, the Commission preliminarily believes that the repropounded Plan amendment requiring the creation of non-voting advisory committees would promote efficiency in the administration of the Plans by allowing interested parties other than SROs to have a voice in Plan matters, which could, in turn, contribute to the resolution of potential disputes that SRO participants would otherwise bring before the Commission or to the courts. Furthermore, repropounded amendments to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) should promote efficiency and competition among market centers by helping to assure that independently reported trade and quotation information is distributed on terms that are fair and reasonable and not unreasonably discriminatory. Repropounded Rule 603(a) would allow investors and vendors greater freedom to make their own decisions regarding the data they need and thus the proposal should lead to lower costs to investors. Broker-dealers who do not need the data beyond the prices, sizes, market center identifications of the NBBO and consolidated last sale information would not be required to receive (and pay for) such data, thereby promoting efficiency. Repropounded Rule 603(b) also should promote efficiency in the dissemination of consolidated market information by requiring that all SROs act jointly through the Plans to disseminate such information to the public.

The Commission preliminarily believes that the proposed Plan amendments would assist in capital formation through a more appropriate

allocation of the Networks' revenues to those SROs that contribute most to public price discovery, and by potentially minimizing costs that may arise from having to resolve disputes relating to the administration of the Plans through broader representation. Repropounded Rule 603(c) also would eliminate the requirement to display a complete montage of quotations from all market centers and should therefore promote capital formation by reducing the costs to vendors and broker-dealers that are currently required to display quotations that may be far away from the NBBO.

The Commission further preliminarily believes that the repropounded amendments to the Plans and to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) would not impose any competitive burden that is not necessary and appropriate in furtherance of the purposes of the Exchange Act. Although modifying the allocation formula could shift revenues among the SRO participants in the Plans, the formula would allocate revenue to those SROs that contribute useful information to the consolidated data stream and thereby would promote competition on terms that will benefit investors. The Commission also preliminarily believes that the repropounded Plan amendment requiring the Plans to form non-voting advisory committees should enhance and promote competition by broadening Plan governance to include non-SRO parties, and thereby provide greater transparency in the administration of such Plans. Furthermore, the repropounded amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) should lessen the burden on vendors and broker-dealers from having to comply with certain consolidated display requirements. Competition among markets also would be enhanced by enabling markets to independently distribute their own market data. In sum, the Commission preliminarily believes that the proposed amendments would enhance rather than burden competition.

### E. Regulation NMS

Repropounded Rule 600, the redesignation of the existing NMS rules as Regulation NMS, and the related proposed conforming changes to other Commission rules should help to promote efficiency and capital formation by making the NMS rules easier to understand, thereby helping to reduce compliance costs for entities subject to the rules. Enhanced clarity in the definitions used in Regulation NMS

<sup>529</sup> See, e.g., Instinet Letter at 47; Mercatus Center Letter at 9-10; Tower Research Letter at 8-11.

also should benefit investors and the public interest by facilitating compliance with the requirements of repropoed Regulation NMS. Because Rule 600 would clarify the existing definitions used in Regulation NMS without imposing new requirements, and because the redesignation of the NMS rules as Regulation NMS and the conforming changes to other Commission rules would create no new substantive requirements, Rule 600 and the related changes should not impose a burden on competition or alter the competitive standing of entities subject to Regulation NMS.

### XI. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"<sup>530</sup> the Commission must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

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

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. The Commission requested comment in the Proposing Release on the potential impact of the proposed regulation on the economy on an annual basis, including a request for commenters to provide empirical data and other factual support for their view to the extent possible.<sup>531</sup> The Commission did not receive any comments specific to the potential impact of the proposed rules on the economy on an annual basis. The Commission renews its request for comment contained in the Proposing Release.

### XII. Regulatory Flexibility Act

Section 3(a) of the Regulatory Flexibility Act<sup>532</sup> requires the Commission to undertake an Initial Regulatory Flexibility Analysis ("IRFA") of the proposed rules and amendments on small entities unless the Commission certifies that the proposed rules and amendments, if

adopted, would not have a significant economic impact on a substantial number of small entities.

#### A. Trade-Through Rule

The Commission hereby certifies, pursuant to Section 603(b) of the Regulatory Flexibility Act,<sup>533</sup> that repropoed Rule 611 would not have a significant economic impact on a substantial number of small entities.<sup>534</sup> Repropoed Rule 611 would require any trading center<sup>535</sup> to establish, maintain, and enforce written policies and procedures reasonably designed to prevent trade-throughs of protected quotations in NMS stocks that do not fall within an exception to the repropoed Rule, and, if relying on such an exception, that are reasonably designed to assure compliance with the terms of the exception. Further, trading centers would be required to regularly surveil to ascertain the effectiveness of such policies and procedures and to take prompt remedial action to remedy deficiencies in such policies and procedures. Thus, only those entities that fall within the definition of trading center would be subject to the repropoed Rule. In addition, brokers-dealers that would not be included within the definition of trading center but that employ their own order smart-routing systems to route orders to multiple trading centers may choose to (but would not be required to) use the intermarket sweep order functionality of the proposed intermarket sweep exception.<sup>536</sup> In addition, vendors that

<sup>533</sup> 5 U.S.C. 603(b).

<sup>534</sup> The Commission included an IRFA in the Proposing Release for proposed Rule 611. Proposing Release, 69 FR at 11151–53. The certificate contained herein is based on a further refinement of the number of entities that would be subject to repropoed Rule 611 and the impact of the repropoed Rule.

<sup>535</sup> A trading center would be defined as a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.

<sup>536</sup> An intermarket sweep order would be defined in Rule 600(b)(30) as a limit order that meets the following requirements: (1) The limit order is identified as an intermarket sweep order when routed to a trading center, and (2) simultaneously with the routing of the limit order, one or more additional orders are routed to execute against all better-priced protected quotations displayed by other trading centers up to their displayed size. These additional orders must be marked to inform the receiving trading center that they are associated with an intermarket sweep order. Paragraph (c)(5) of repropoed Rule 611 would allow a trading center to execute immediately any order identified as an intermarket sweep order, without regard for better-priced protected quotations displayed at one or more other trading centers. Similarly, paragraph (c)(6) of repropoed Rule 611 would authorize a trading center itself to route intermarket sweep

would not be subject to repropoed Rule 611 may need to make system modifications to support the operation of the repropoed Rule.

The current national securities exchanges and one national securities association that would be subject to the proposed Rule are not considered "small entities" for purposes of the Regulatory Flexibility Act.<sup>537</sup> The remaining trading centers that would be subject to repropoed Rule 611 are registered broker-dealers. The Commission has preliminarily determined that approximately 600 broker-dealers registered with the Commission,<sup>538</sup> which includes broker-dealers operating as equity ATs, broker-dealers registered as market makers or specialists in NMS stocks, and any broker-dealer that is in the business of executing orders internally in NMS stocks, would be subject to repropoed Rule 611. Of these 600 broker-dealers, only two are considered small for purposes of the Regulatory Flexibility Act pursuant to the standards of Rule 0–10(c) under the Exchange Act.<sup>539</sup>

With respect to non-trading center broker-dealers that employ their own smart-order routing technology and that would choose to route orders in compliance with the proposed intermarket sweep exception (and thus would need to make necessary modifications to their order routing practices and proprietary order routing systems), the Commission preliminarily does not believe that this category of broker-dealers would be very large, and also preliminarily does not believe that any such broker-dealer that would employ its own order routing systems would be considered small, given the cost of operating such proprietary systems.<sup>540</sup> The Commission also believes it likely that, given the nature of their business, most if not all of these non-trading center broker-dealers that employ their own order-routing technology already have systems in place that monitor best-priced quotations across markets, and thus

orders and thereby enable immediate execution of a transaction at a price inferior to a protected quotation at another trading center.

<sup>537</sup> See 17 CFR 240.0–10(e) and 13 CFR 121.201.

<sup>538</sup> See *supra* note 426.

<sup>539</sup> Pursuant to Rule 0–10(c) under the Exchange Act, 17 CFR 240.0–10(c), a broker-dealer is defined as a small entity for purposes of the Exchange Act and the Regulatory Flexibility Act if the broker-dealer had a total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, and it is not affiliated with any person (other than a natural person) that is not a small entity.

<sup>540</sup> *Id.*

<sup>530</sup> Pub. L. No. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

<sup>531</sup> Proposing Release, 69 FR at 11151, 11162, 11174, 11189–90, 11198.

<sup>532</sup> 5 U.S.C. 603(a).

preliminarily does not believe that the changes necessary to implement the intermarket sweep order would be significant. With respect to any vendor that may determine to make systems modifications to support the operation of repropoed Rule 611, only 16 of the approximately 80 existing vendors are considered small.<sup>541</sup> Accordingly, the Commission does not believe that repropoed Rule 611 would have a significant economic impact on a substantial number of small entities.

The Commission encourages written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact. In particular, the Commission requests comment on (a) the number of small entities that would be affected by repropoed Rule 611; (b) the nature of any impact repropoed Rule 611 would have on small entities and empirical data supporting the extent of the impact; and (c) how to quantify the number of small entities that would be affected by or how to quantify the impact of repropoed Rule 611.

#### B. Access Rule

The Commission hereby certifies, pursuant to Section 603(b) of the Regulatory Flexibility Act,<sup>542</sup> that repropoed Rule 610 and the repropoed amendments to Rule 301 of Regulation ATS would not have a significant economic impact on a substantial number of small entities.<sup>543</sup> Repropoed Rule 610 would prohibit any trading

center<sup>544</sup> from imposing unfairly discriminatory terms that would prevent or inhibit the access of any person through members, subscribers, or customers of such trading center. Further, the repropoed Rule would restrict access fees imposed by trading centers to a maximum of \$0.003 per share. Finally, repropoed Rule 610 would require national securities exchanges and national securities associations to establish and enforce rules that, among other things, prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross the automated quotations of other trading centers. Thus, repropoed Rule 610 would impact only those entities that fall within the definition of trading center. The repropoed access provisions also would lower the threshold that triggers the fair access requirements in Rule 301 of Regulation ATS from 20% to 5% of average daily volume in a security. This amendment would potentially impact the existing operating ATSS.

The current national securities exchanges and national securities association that would be subject to the repropoed Rule are not considered "small entities" for purposes of the Regulatory Flexibility Act.<sup>545</sup> The remaining entities that would be subject to repropoed Rule 610 and the repropoed amendments to Rule 301 of Regulation ATS are registered broker-dealers. The Commission has preliminarily determined that approximately 600 broker-dealers registered with the Commission,<sup>546</sup> which includes broker-dealers operating as equity ATSS, broker-dealers registered as market makers or specialists in NMS stocks, and any other broker-dealer that is in the business of executing orders internally, would be subject to Rule 610. In addition, the existing operating ATSS (which are or are operated by registered broker-dealers) potentially could be subject to the repropoed amendment to Rule 301 of Regulation ATS. Of these broker-dealers, only two are considered small for purposes of the Regulatory Flexibility Act pursuant to the standards of Rule 0-10(c) under the Exchange Act.<sup>547</sup> Accordingly, the Commission

preliminarily does not believe that repropoed Rule 610 and the repropoed amendments to Rule 301 of Regulation ATS would have a significant economic impact on a substantial number of small entities.

The Commission encourages written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact. In particular, the Commission requests comment on (a) the number of small entities that would be affected by repropoed Rule 610 and the repropoed amendment to Rule 301 of Regulation ATS; (b) the nature of any impact repropoed Rule 610 and the repropoed amendment to Rule 301 of Regulation ATS would have on small entities and empirical data supporting the extent of the impact; and (c) how to quantify the number of small entities that would be affected by or how to quantify the impact of repropoed Rule 610 and the repropoed amendment to Rule 301 of Regulation ATS.

#### C. Sub-Penny Rule

This IRFA relating to repropoed Rule 612 has been prepared in accordance with 5 U.S.C. 603. This IRFA is substantially the same as the one contained in the Proposing Release.<sup>548</sup> The Commission did not receive any comment on the IRFA contained in the Proposing Release.

##### 1. Reasons for the Proposed Action

The Commission is concerned that, while the conversion from fractions to decimals benefited investors by clarifying and simplifying pricing for investors, making our markets more competitive internationally, and reducing trading costs by narrowing spreads, these benefits could be sacrificed by decreasing the MPV from a penny to pricing increments finer than a penny. The Commission is particularly concerned that sub-penny orders can be used to step ahead of competing limit orders for an economically insignificant amount.

The Commission believes that this would be an opportune time to address these issues by proposing a uniform standard of quoting in NMS stocks. The Commission is thus proposing to prohibit any vendor, exchange, association, broker-dealer, or ATS (including ECNs) from accepting, ranking, or displaying quotations, orders, or indications of interest in NMS stocks in sub-penny increments (except for quotations, orders, or indications of

<sup>541</sup> A vendor is defined as any securities information processor engaged in the business of disseminating transaction reports or last sale data with respect to transactions in reported securities to brokers, dealers or investors on a real-time or other current and continuing basis, whether through an ECN, moving ticker or interrogation device. See 17 CFR 11Aa3-1(a)(11). Rule 0-10(g) states that the term "small business" or "small organization," when referring to a securities information processor, means any securities information processor that: (1) Had gross revenues of less than \$10 million during the preceding fiscal year (or in the time it has been in business, if shorter); (2) provided service to fewer than 100 interrogation devices or moving tickers at all times during the preceding fiscal year (or in the time that it has been in business, if shorter); and (3) is not affiliated with any person (other than a natural person) that is not a small business or small organization under this section. 17 CFR 240.0-10(g). The Commission estimates that there are approximately 80 vendors, only 16 of which are considered small entities.

<sup>542</sup> 5 U.S.C. 603(b).

<sup>543</sup> The Commission included an IRFA for the access proposal in the Proposing Release. Proposing Release, 69 FR at 11162-63. The certification contained herein is based on a further refinement of the entities that would be subject to repropoed access requirements and the impact of the proposed rules.

<sup>544</sup> A trading center would be defined as a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.

<sup>545</sup> See 17 CFR 240.0-10(e) and 13 CFR 121.201.

<sup>546</sup> See *supra* note 426.

<sup>547</sup> See *supra* note 539.

<sup>548</sup> Proposing Release, 69 FR at 11174-75.

interest priced less than \$1.00 per share, in which case the price may not extend beyond four decimal places).

## 2. Objectives

The repropoed rule is designed to fulfill several objectives. Repropoed Rule 612 is designed to prevent widespread quoting in sub-pennies, which could harm the markets and investors, by undermining a number of the benefits of decimalization. In particular, sub-penny quotation could impair broker-dealers' efforts to meet their best execution obligations, and interfere with investors' understanding of securities prices. In addition, the repropoed rule is designed to enhance depth by preventing quotations from being spread across an increasing number of price points, while also encouraging the use of limit orders—an important source of liquidity—by preventing competing market participants from stepping ahead of limit orders for an economically insignificant amount.

## 3. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 3(b), 5, 6, 11A, 15, 15A, 17(a) and (b), 19, 23(a), and 36 thereof, 15 U.S.C. 78c(b), 78e, 78f, 78k-1, 78o, 78mm, 78q(a) and (b), and 78w(a), the Commission repropoed Rule 612.

## 4. Small Entities Subject to the Rule

The repropoed rule would apply to any national securities exchange, national securities association, ATS, vender, or broker or dealer. ATSs that are not registered as exchanges are required to register as broker-dealers. Accordingly, ATSs would be considered small entities if they fall within the standard for small entities that would apply to broker-dealers. Each type of market participant that would be affected by the repropoed rule is discussed below.

### a. National Securities Exchanges and National Securities Association

Rule 0-10(e) under the Exchange Act<sup>549</sup> provides that the term "small business" or "small organization," when referring to an exchange, means any exchange that: (1) Has been exempted from the reporting requirements of Rule 11Aa3-1 under the Exchange Act; and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization, as defined by Rule 0-10. No national securities exchanges are small entities because none meets

these criteria. There is one national securities association (NASD) that would be subject to repropoed Rule 612. NASD is not a small entity as defined by 13 CFR 121.201.

### b. Broker-Dealers

Commission rules generally define a broker-dealer as a small entity for purposes of the Exchange Act and the Regulatory Flexibility Act if the broker-dealer had a total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, and the broker-dealer is not affiliated with any person (other than a natural person) that is not a small entity.<sup>550</sup> The Commission estimates that as of the end of 2003, there were approximately 6,565 Commission-registered broker-dealers,<sup>551</sup> of which approximately 905 would be considered small entities pursuant to the standard of Rule 0-10(c) under the Exchange Act.<sup>552</sup>

### c. Vendors

A vendor is defined as any securities information processor engaged in the business of disseminating transaction reports or last sale data with respect to transactions in reported securities to brokers, dealers or investors on a real-time or other current and continuing basis, whether through an ECN, moving ticker or interrogation device.<sup>553</sup> Rule 0-10(g)<sup>554</sup> states that the term "small business" or "small organization," when referring to a securities information processor, means any securities information processor that: (1) Had gross revenues of less than \$10 million during the preceding fiscal year (or in the time it has been in business, if shorter); (2) provided service to fewer than 100 interrogation devices or moving tickers at all times during the preceding fiscal year (or in the time that it has been in business, if shorter); and (3) is not affiliated with any person (other than a natural person) that is not a small business or small organization under this section. The Commission estimates that there are approximately 80 vendors, 16 of which are considered small entities. The Commission seeks comment on whether these estimates are accurate.

<sup>550</sup> 17 CFR 240.0-10(c).

<sup>551</sup> This number reflects the number of FOCUS filings.

<sup>552</sup> 17 CFR 240.0-10(c).

<sup>553</sup> See 17 CFR 11Aa3-1(a)(11).

<sup>554</sup> 17 CFR 240.0-10(g).

## 5. Reporting, Recordkeeping, and Other Compliance Requirements

Repropoed Rule 612 would not impose any new reporting, recordkeeping or other compliance requirements on market participants that are small entities.

## 6. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap or conflict with the proposed rule.

## 7. Significant Alternatives

Pursuant to Section 3(a) of the RFA,<sup>555</sup> the Commission must consider the following types of alternatives: (1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rule for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the proposed rule, or any part thereof, for small entities.

The primary goal of the repropoed rule is to provide a uniform pricing increment for NMS stocks. As such, imposing different compliance or reporting requirements, and possibly a different timetable for implementing compliance or reporting requirements, for small entities could undermine the goal of uniformity. In addition, the Commission preliminarily believes that it would not be consistent with the primary goal of the proposal to further clarify, consolidate, or simplify the repropoed rule for small entities. The Commission also does not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed rule because the rule already repropoed performance standards and does not dictate for entities of any size any particular design standards (*e.g.*, technology) that must be employed to achieve the objectives of the proposed rule. The Commission also preliminarily believes that it would be inconsistent with the purposes of the Exchange Act to specify different requirements for small entities or to exempt broker-dealers from the proposed rule.

## 8. Request for Comments

The Commission encourages written comments on matters discussed in the IRFA. In particular, the Commission

<sup>555</sup> 5 U.S.C. 603(c).

<sup>549</sup> 17 CFR 240.0-10(e).

requests comments on (i) the number of small entities that would be affected by the repropoed rule; (ii) the nature of any impact the repropoed rule would have on small entities and empirical data supporting the extent of the impact; and (iii) how to quantify the number of small entities that would be affected by and how to quantify the impact of the repropoed rule. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the repropoed rule is adopted, and will be placed in the same public file as comments on the repropoed rule itself.

#### *D. Market Data Rules and Plan Amendments*

##### 1. Regulatory Flexibility Act Certification for the Plan Amendments

Pursuant to 5 U.S.C. 605(b) of the Regulatory Flexibility Act,<sup>556</sup> the Commission certified in the Proposing Release that amending the Plans to (1) modify the current formulas for allocating market data revenues, and (2) require the establishment of non-voting advisory committees would not have a significant economic impact on a substantial number of small entities.<sup>557</sup> The Commission did not receive any comments on the certification. The Commission renews its request for comment on the certification, which is set forth below.

The Commission hereby certifies, pursuant to 5 U.S.C. 603(b), that the repropoed amendments to the Plans, if adopted, would not have a significant economic impact on a substantial number of small entities. The repropoed amendments to the Plans imposing a new net income allocation formula would only impact the SROs,<sup>558</sup> SIAC (the processor for the CTA Plans and the CQ Plan), and Nasdaq (the processor for the Nasdaq UTP Plan). The repropoed amendments to the Plans requiring the establishment of an advisory committee would apply only to Plan participants. SIAC and Nasdaq would not be considered "small entities" for purposes of the Regulatory Flexibility Act.<sup>559</sup> The Plan participants are either national securities exchanges or a national securities association and,

as such, are not small entities.<sup>560</sup> Accordingly, the Commission does not believe that the repropoed amendments to the Plans would have a significant economic impact on a substantial number of small entities.

##### 2. Initial Regulatory Flexibility Analysis for Proposed Amendments to Rules 11Aa3-1 and 11Ac1-2 (Proposed To Be Redesignated as Rules 601 and 603)

This IRFA has been prepared in accordance with 5 U.S.C. 603. It relates to the proposed amendments to Rules 11Aa3-1 and 11Ac1-2 under the Exchange Act (proposed to be redesignated as Rules 601 and 603 of Regulation NMS).<sup>561</sup> This IRFA is substantially the same as the one contained in the Proposing Release.<sup>562</sup> The Commission did not receive any comment on the IRFA contained in the Proposing Release.

##### a. Reasons for the Proposed Action

The Commission believes that an overall modernization of the rules for disseminating market data to the public is necessary to address problems posed by the current market data rules. The Commission proposes to retain the core elements of the current rules—price discovery and mandatory consolidation—which provide important benefits to investors and to others who use market information, while amending other parts of the current rules that have resulted in serious economic and regulatory distortions. More specifically, the Commission repropoed to amend Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) to lift certain restrictions in order to reduce the burden on and to provide simplification and uniformity for those market centers, broker-dealers, and data vendors that have to comply with requirements under the Rules.

##### b. Objectives

The repropoed amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) are designed to fulfill several objectives. First, the repropoed amendment to Rule 11Aa3-1 (proposed to be redesignated as Rule 601) is intended to provide market centers, including ATSS and market makers, with flexibility to independently distribute their own trade reports, aside from their obligation to provide their trade reports to an SRO or to the Networks (depending on the

type of market center). Second, a prime objective of the repropoed amendments to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) is to provide uniform standards for all market centers, including non-SRO market centers and entities that are exclusive processors of SRO market data, for the independent distribution of market data. Third, the objective of the repropoed amendment to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) providing that all SROs act jointly through the Plans and disseminate their consolidated information through a single processor is to clarify the current practice among the SROs and to require continued participation in the Plans and dissemination through one processor per security. Fourth, an additional objective of the repropoed amendments to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) is to reduce consolidated display requirements on broker-dealers and vendors and to limit their consolidated display obligations to the disclosure of the NBBO and consolidated last sale information, and to the display of market information in a trading or order-routing context. Finally, the repropoed amendments to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) are intended to ease the burden of compliance by simplifying the current consolidated display requirements under the Rule and by rescinding old provisions in the Rule that are outdated and no longer necessary.

##### c. Legal Basis

The Commission repropoed amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) pursuant to its authority set forth in Sections 2, 3(b), 5, 6, 11A, 15, 15A, 17(a), 19, 23(a), and 36 of the Exchange Act, and Rules 11Aa3-2(b)(2) and 11Aa3-2(c)(1) thereunder.<sup>563</sup>

##### d. Small Entities Subject to the Rule

The repropoed amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) would affect ATSS, market makers, broker-dealers, and SIPs that could potentially be small entities. Paragraph (c) of Rule 0-10 under the Exchange Act<sup>564</sup> defines the term "small business" or "small organization," when referring to a broker-dealer, to mean a broker or dealer that had total capital of less than \$500,000 on the date in the prior fiscal year as of which its

<sup>556</sup> 5 U.S.C. 605(b).

<sup>557</sup> Proposing Release, 69 FR at 11190-91.

<sup>558</sup> Paragraph (e) of Exchange Act Rule 0-10 provides that the term "small entity," when referring to an exchange, means any exchange that has been exempted from the reporting requirements of 17 CFR 240.11Aa3-1 and is not affiliated with any person that is not a small entity. Under this standard, none of the exchanges affected by the proposed rule is a small entity. Similarly, the national securities association affected by the proposed rule is not small entity as defined by 13 CFR 121.201.

<sup>559</sup> See 17 CFR 240.0-10(g).

<sup>560</sup> See 17 CFR 240.0-10(e).

<sup>561</sup> 17 CFR 240.11Aa3-1 and 17 CFR 240.11Ac1-2.

<sup>562</sup> Proposing Release, 69 FR 11190-91.

<sup>563</sup> 15 U.S.C. 78b, 78c(b), 78e, 78f, 78k-1, 78o, 78o-3, 78q(a), 78s; 78w(a), and 78mm; 17 CFR 240.11Aa3-2(b)(2) and 17 CFR 240.11Aa3-2(c)(1).

<sup>564</sup> 17 CFR 240.0-10(c).



audited financial statements were prepared, or if not required to file such statements, it had total capital of less than \$500,000 on the last business day of the preceding fiscal year; and is not affiliated with any person (other than a natural person) that is not a small business or small organization. ATSS and market makers would be considered broker-dealers for purposes of this definition. Paragraph (g) of Rule 0-10<sup>565</sup> defines the term "small business" or "small organization," when referring to a SIP, to mean a SIP that had gross revenues of less than \$10 million during the preceding fiscal year and provided service to fewer than 100 interrogation devices or moving tickers at all times during the preceding fiscal year; and is not affiliated with any person (other than a natural person) that is not a small business or small organization.

As of December 31, 2003, the Commission estimates that there are approximately 905 registered broker-dealers, including ATSS and market makers, that would be considered small entities. In addition, approximately 16 SIPs would be considered small entities. The Commission's repropoed amendment to Rule 11Aa3-1 (proposed to be redesignated as Rule 601) would enable small market centers, including ATSS and market makers, that contribute to consolidated information, if they so choose, to also independently distribute their own trade reports. The Commission's repropoed amendments to Rule 11Ac1-2 (proposed to be redesignated as Rule 603) would reduce the compliance burden on small broker-dealers and SIPs by limiting the data required to be consolidated and displayed under the rule.<sup>566</sup>

The Commission requests comment on the number of small entities that would be impacted by the repropoed amendments, including any available empirical data.

#### e. Reporting, Recordkeeping and Other Compliance Requirements

The repropoed amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) would not impose any new reporting, recordkeeping or other compliance requirements on ATSS, market makers, broker-dealers, and SIPs that are small entities. SROs that would be subject to

these repropoed amendments would not be considered small entities.

#### f. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap or conflict with the repropoed amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603).

#### g. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the repropoed amendments, the Commission has considered the following alternative models for disseminating market data to the public: (1) A competing consolidators model under which each SRO would be allowed to sell its market data separately to any number of consolidators; (2) a rescission of the consolidated display requirement and allowing all SROs and other market centers to distribute their market data individually; and (3) a hybrid model that would retain the consolidated display requirement and existing Networks solely for the dissemination of the NBBO, but allow the SROs to distribute their own quotations and trades independently and without a consolidated display requirement. These alternative models were all intended to introduce more competition in the marketplace and greater flexibility in market data dissemination.

The primary goal of the repropoed amendments to Rules 11Aa3-1 and 11Ac1-2 (proposed to be redesignated as Rules 601 and 603) is to retain the benefits of the consolidated display requirement, which provides a uniform, consolidated stream of data and is the single most important tool for unifying all of the market centers trading NMS Stocks, while providing market centers that contribute to consolidated information with the ability to independently distribute their own market data and reducing the consolidated display requirements on broker-dealers and SIPs. The Commission preliminarily believes that these potential alternative models pose an unacceptable risk of losing important benefits that investors and other information users receive under the current system—an affordable and highly reliable stream of quotations and trades that is consolidated from all significant market centers trading an NMS Stock. The Commission also does

not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed amendments as the amendments already propose performance standards and do not dictate for entities of any size any particular design standards (*e.g.*, technology) that must be employed to achieve the objectives of the proposed amendments.

#### h. Solicitation of Comments

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

#### E. Regulation NMS

Pursuant to 5 U.S.C. 605(b), the Commission certified in the Proposing Release that proposed Rule 600 and the redesignation of the NMS rules as Regulation NMS would not have a significant economic impact on a substantial number of small entities.<sup>567</sup> The Commission received no comments regarding this certification. The Commission renews its request for comment on the certification, which is set forth below.

The Commission hereby certifies, pursuant to 5 U.S.C. 605(b), that repropoed Rule 600 and the related repropoed amendments, if adopted, would not have a significant economic impact on a substantial number of small entities. Repropoed Rule 600 would revise and clarify the definitions used in proposed Regulation NMS, thereby facilitating compliance with proposed Regulation NMS and potentially easing the compliance burden on entities seeking to comply with the regulation. Neither repropoed Rule 600 nor the related repropoed amendments of the NMS rules would alter the existing requirements of the NMS rules. Accordingly, the Commission does not

<sup>565</sup> 17 CFR 240.0-10(g).

<sup>566</sup> The repropoed amendment to Rule 11Ac1-2 (proposed to be redesignated as Rule 603), providing that all SROs act jointly through the Plans and disseminate their consolidated information through a single processor would only apply to the SROs, which are not "small entities" for purposes of the Regulatory Flexibility Act.

<sup>567</sup> Proposing Release, 69 FR at 11198.

believe that re-proposed Rule 600 and the re-designation of the NMS rules as proposed Regulation NMS would have a significant impact on a substantial number of small entities.

### XIII. Statutory Authority

Pursuant to the Exchange Act and particularly, Sections 2, 3(b), 5, 6, 11A, 15, 15A, 17(a) and (b), 19, 23(a), and 36 thereof, 15 U.S.C. 78b, 78c(b), 78e, 78f, 78k-1, 78o, 78o-3, 78q(a) and (b), 78s; 78w(a), and 78mm, and Rules 11Aa3-2(b)(2) and 11Aa3-2(c)(1) thereunder, 17 CFR 240.11Aa3-2(b)(2) and 17 CFR 240.11Aa3-2(c)(1), the Commission proposes to: (1) Redesignate the NMS rules under Section 11A of the Exchange Act as Regulation NMS rules; (2) adopt Rules 600, 610, 611, and 612 of Regulation NMS; (3) amend current Rules 11Aa3-1 and 11Ac1-2 under the Exchange Act and redesignate them as Rules 601 and 603 of Regulation NMS; (4) amend the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan; and (5) amend various other rules to reflect the adoption of Regulation NMS, as set forth below.

### XIV. Text of Proposed Amendments to the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan

The Commission hereby proposes to amend the CTA Plan, the CQ Plan, and the Nasdaq UTP Plan to incorporate the new net income allocation formula into each Plan, which would supersede the existing allocation formulas in those Plans, and to incorporate the new Plan governance language into each Plan.

Set forth below is the text of (1) the proposed new allocation formula to be incorporated into each of the Plans, and (2) the proposed new Plan governance language to be incorporated into each of the Plans.

#### Formula Amendment

##### (#) Allocation of Net Income.

(a) *Annual Payment.* Notwithstanding any other provision of this Plan, each Participant eligible to receive distributable net income under the Plan shall receive an annual payment for each calendar year that is equal to the sum of the Participant's Trading Shares and Quoting Shares, as defined below, in each Eligible Security for the calendar year.

(b) *Security Income Allocation.* The Security Income Allocation for an Eligible Security shall be determined by multiplying (i) the distributable net income of the Plan for the calendar year by (ii) the Volume Percentage for such Eligible Security. The Volume Percentage for an Eligible Security shall be determined by dividing (i) the square

root of the dollar volume of transaction reports disseminated by the Processor in such Eligible Security during the calendar year divided by (ii) the sum of the square roots of the dollar volume of transaction reports disseminated by the Processor in each Eligible Security during the calendar year.

(c) *Trading Share.* The Trading Share of a Participant in an Eligible Security shall be determined by multiplying (i) an amount equal to the lesser of (A) fifty percent of the Security Income Allocation for the Eligible Security or (B) an amount equal to \$2.00 multiplied by the total number of qualified transaction reports disseminated by the Processor in the Eligible Security during the calendar year, by (ii) the Participant's Trade Rating in the Eligible Security. A Participant's Trade Rating in an Eligible Security shall be determined by taking the average of (i) the Participant's percentage of the total dollar volume of transaction reports disseminated by the Processor in the Eligible Security during the calendar year, and (ii) the Participant's percentage of the total number of qualified transaction reports disseminated by the Processor in the Eligible Security during the calendar year. A transaction report with a dollar volume of \$5000 or more shall constitute one qualified transaction report. A transaction report with a dollar volume of less than \$5000 shall constitute a fraction of a qualified transaction report that equals the dollar volume of the transaction report divided by \$5000.

(d) *Quoting Share.* The Quoting Share of a Participant in an Eligible Security shall be determined by multiplying (i) an amount equal to fifty percent of the Security Income Allocation for the Eligible Security, plus the difference, if greater than zero, between fifty percent of the Security Income Allocation for the Eligible Security and an amount equal to \$2.00 multiplied by the total number of qualified transaction reports disseminated by the Processor in the Eligible Security during the calendar year, by (ii) the Participant's Quote Rating in the Eligible Security. A Participant's Quote Rating in an Eligible Security shall be determined by dividing (i) the sum of the Quote Credits earned by the Participant in such Eligible Security during the calendar year by (ii) the sum of the Quote Credits earned by all Participants in such Eligible Security during the calendar year. A Participant shall earn one Quote Credit for each second of time multiplied by dollar value of size that a firm automated bid (offer) transmitted by the Participant to the Processor

during regular trading hours is equal to the price of the national best bid (offer) in the Eligible Security. An automated bid (offer) shall have the meaning specified in Rule 600 of Regulation NMS of the Exchange Act for an "automated quotation." The dollar value of size of a quote shall be determined by multiplying the price of a quote by its size.

#### Governance Amendment

##### (#) Advisory Committee.

(a) *Formation.* Notwithstanding any other provision of this Plan, an Advisory Committee to the Plan shall be formed and shall function in accordance with the provisions set forth in this section.

(a) *Composition.* Members of the Advisory Committee shall be selected for two-year terms as follows:

(1) *Operating Committee Selections.* By affirmative vote of a majority of the Participants entitled to vote, the Operating Committee shall select at least one representative from each of the following categories to be members of the Advisory Committee: (i) A broker-dealer with a substantial retail investor customer base, (ii) a broker-dealer with a substantial institutional investor customer base, (iii) an alternative trading system, (iv) a data vendor, and (v) an investor.

(2) *Participant Selections.* Each Participant shall have the right to select one member of the Advisory Committee. A Participant shall not select any person employed by or affiliated with any Participant or its affiliates or facilities.

(c) *Function.* Members of the Advisory Committee shall have the right to submit their views to the Operating Committee on Plan matters, prior to a decision by the Operating Committee on such matters. Such matters shall include, but not be limited to, any new or modified product, fee, contract, or pilot program that is offered or used pursuant to the Plan.

(d) *Meetings and Information.* Members of the Advisory Committee shall have the right to attend all meetings of the Operating Committee and to receive any information concerning Plan matters that is distributed to the Operating Committee; provided, however, that the Operating Committee may meet in executive session if, by affirmative vote of a majority of the Participants entitled to vote, the Operating Committee determines that an item of Plan business requires confidential treatment.

**XV. Text of Reproposed Rules**

**List of Subjects**

*17 CFR Part 200*

Administrative practice and procedure, Authority delegations (Government agencies), Organization and functions (Government agencies).

*17 CFR Part 201*

Administrative practice and procedure, Securities.

*17 CFR Parts 230 and 270*

Reporting and recordkeeping requirements, Securities.

*17 CFR Parts 240, 242, and 249*

Brokers, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II of the Code of the Federal Regulations is proposed to be amended as follows:

**PART 200—ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS**

1. The general authority citation for part 200 is revised to read as follows:

**Authority:** 15 U.S.C. 77s, 78d, 78d-1, 78d-2, 78w, 78ll(d), 78mm, 79t, 77sss, 80a-37, 80b-11 and 7202 unless otherwise noted.

2. Section 200.30-3 is amended by:

- a. Removing paragraphs (a)(62) and (a)(71);
- b. Redesignating paragraphs (a)(63) through (a)(82) as paragraphs (a)(62) through (a)(80);
- c. Revising paragraphs (a)(27), (a)(28), (a)(36), (a)(37), (a)(42), (a)(49), (a)(61), and newly redesignated paragraphs (a)(68), and (a)(69); and
- d. Adding new paragraphs (a)(81), (a)(82), and (a)(83).

The revisions and additions read as follows:

**§ 200.30-3 Delegation of authority to Director of Division of Market Regulation.**

\* \* \* \* \*

(a) \* \* \*  
 (27) To approve amendments to the joint industry plan governing consolidated transaction reporting declared effective by the Commission pursuant to Rule 601 (17 CFR 242.601) or its predecessors, Rule 11Aa3-1 and Rule 17a-15, and to grant exemptions from Rule 601 pursuant to Rule 601(f) (17 CFR 242.601(f)) to exchanges trading listed securities that are designated as national market system securities until such times as a Joint Reporting Plan for such securities is filed and approved by the Commission.

(28) To grant exemptions from Rule 602 (17 CFR 242.602), pursuant to Rule 602(d) (17 CFR 242.602(d)).

\* \* \* \* \*

(36) To grant exemptions from Rule 603 (17 CFR 242.603), pursuant to Rule 603(d) (17 CFR 242.603(d)).

(37) Pursuant to Rule 600 (17 CFR 242.600), to publish notice of the filing of a designation plan with respect to national market system securities, or any proposed amendment thereto, and to approve such plan or amendment.

\* \* \* \* \*

(42) Under 17 CFR 242.608(e), to grant or deny exemptions from 17 CFR 242.608.

\* \* \* \* \*

(49) Pursuant to section 11A(b) of the Act (15 U.S.C. 78k-1(b)) and Rule 609 thereunder (17 CFR 242.609), to publish notice of and, by order, grant under section 11A(b) of the Act and Rule 609 thereunder: Applications for registration as a securities information processor; and exemptions from that section and any rules or regulations promulgated thereunder, either conditionally or unconditionally.

\* \* \* \* \*

(61) To grant exemptions from Rule 604 (17 CFR 242.604), pursuant to Rule 604(c) (17 CFR 242.604(c)).

\* \* \* \* \*

(68) Pursuant to Rule 605(b) (17 CFR 242.605(b)), to grant or deny exemptions, conditionally or unconditionally, from any provision or provisions of Rule 605 (17 CFR 242.605).

(69) Pursuant to Rule 606(c) (17 CFR 242.606(c)), to grant or deny exemptions, conditionally or unconditionally, from any provision or provisions of Rule 606 (17 CFR 242.606).

\* \* \* \* \*

(81) To grant or deny exemptions from Rule 610 (17 CFR 242.610), pursuant to Rule 610(e) (17 CFR 242.610(e)).

(82) To grant or deny exemptions from Rule 611 (17 CFR 242.611), pursuant to Rule 611(d) (17 CFR 242.611(d)).

(83) To grant or deny exemptions from Rule 612 (17 CFR 242.612), pursuant to Rule 612(c) (17 CFR 242.612(c)).

**Subpart N—Commission Information Collection Requirements Under the Paperwork Reduction Act: OMB Control Numbers**

3. The authority citation for Subpart N continues to read as follows:

**Authority:** 44 U.S.C. 3506; 44 U.S.C. 3507.

4. Section 200.800 is amended by revising paragraph (b) to read as follows:

**§ 200.800 OMB control numbers assigned pursuant to the Paperwork Reduction Act.**

(a) \* \* \*

(b) *Display.*

Information collection requirement	17 CFR part or section where identified and described	Current OMB Control No.
Regulation S-X .....	Part 210 .....	3235-0009
Regulation S-B .....	Part 228 .....	3235-0417
Regulation S-K .....	Part 229 .....	3235-0071
Rule 154 .....	230.154 .....	3235-0495
Rule 155 .....	230.155 .....	3235-0549
Rule 236 .....	230.236 .....	3235-0095
Rule 237 .....	230.237 .....	3235-0528
Regulation A .....	230.251 thru 230.263 .....	3235-0286
Regulation C .....	230.400 thru 230.494 .....	3235-0074
Rule 425 .....	230.425 .....	3235-0521
Rule 477 .....	230.477 .....	3235-0550
Rule 489 .....	230.489 .....	3235-0411
Rule 498 .....	230.498 .....	3235-0488
Regulation D .....	230.501 thru 230.506 .....	3235-0076
Regulation E .....	230.601 thru 230.610a .....	3235-0232
Rule 604 .....	230.604 .....	3235-0232
Rule 605 .....	230.605 .....	3235-0232
Rule 609 .....	230.609 .....	3235-0233
Rule 701 .....	230.701 .....	3235-0522

Information collection requirement	17 CFR part or section where identified and described	Current OMB Control No.
Regulation S	230.901 thru 230.905	3235-0357
Regulation S-T	Part 232	3235-0424
Form SB-1	239.9	3235-0423
Form SB-2	239.10	3235-0418
Form S-1	239.11	3235-0065
Form S-2	239.12	3235-0072
Form S-3	239.13	3235-0073
Form N-2	239.14	3235-0026
Form N-1A	239.15A	3235-0307
Form S-6	239.16	3235-0184
Form S-8	239.16b	3235-0066
Form N-3	239.17a	3235-0316
Form N-4	239.17b	3235-0318
Form S-11	239.18	3235-0067
Form N-14	239.23	3235-0336
Form N-5	239.24	3235-0169
Form S-4	239.25	3235-0324
Form F-1	239.31	3235-0258
Form F-2	239.32	3235-0257
Form F-3	239.33	3235-0256
Form F-4	239.34	3235-0325
Form F-6	239.36	3235-0292
Form F-7	239.37	3235-0383
Form F-8	239.38	3235-0378
Form F-9	239.39	3235-0377
Form F-10	239.40	3235-0380
Form F-80	239.41	3235-0404
Form F-X	239.42	3235-0379
Form F-N	239.43	3235-0411
Form ET	239.62	3235-0329
Form ID	239.63	3235-0328
Form SE	239.64	3235-0327
Form TH	239.65	3235-0425
Form 1-A	239.90	3235-0286
Form 2-A	239.91	3235-0286
Form 144	239.144	3235-0101
Form 1-E	239.200	3235-0232
Form CB	239.800	3235-0518
Rule 6a-1	240.6a-1	3235-0017
Rule 6a-3	240.6a-3	3235-0021
Rule 6a-4	240.6a-4	3235-0554
Rule 6h-1	240.6h-1	3235-0555
Rule 8c-1	240.8c-1	3235-0514
Rule 9b-1	240.9b-1	3235-0480
Rule 10a-1	240.10a-1	3235-0475
Rule 10b-10	240.10b-10	3235-0444
Rule 10b-17	240.10b-17	3235-0476
Rule 10b-18	240.10b-18	3235-0474
Rule 10A-1	240.10A-1	3235-0468
Rule 11a1-1(T)	240.11a1-1(T)	3235-0478
Rule 12a-5	240.12a-5	3235-0079
Regulation 12B	240.12b-1 thru 240.12b-36	3235-0062
Rule 12d1-3	240.12d1-3	3235-0109
Rule 12d2-1	240.12d2-1	3235-0081
Rule 12d2-2	240.12d2-2	3235-0080
Rule 12f-1	240.12f-1	3235-0128
Rule 13a-16	240.13a-16	3235-0116
Regulation 13D/G	240.13d-1 thru 240.13d-7	3235-0145
Schedule 13D	240.13d-101	3235-0145
Schedule 13G	240.13d-102	3235-0145
Rule 13e-1	240.13e-1	3235-0305
Rule 13e-3	240.13e-3	3235-0007
Schedule 13E-3	240.13e-100	3235-0007
Schedule 13e-4F	240.13e-101	3235-0375
Regulation 14A	240.14a-1 thru 240.14a-12	3235-0059
Schedule 14A	240.14a-101	3235-0059
Regulation 14C	240.14c-1	3235-0057
Schedule 14C	240.14c-101	3235-0057
Regulation 14D	240.14d-1 thru 240.14d-9	3235-0102
Schedule TO	240.14d-100	3235-0515
Schedule 14D-1	240.14d-101	3235-0102
Schedule 14D-9	240.14d-101	3235-0102
Schedule 14D-1F	240.14d-102	3235-0376

Information collection requirement	17 CFR part or section where identified and described	Current OMB Control No.
Schedule 14D-9F	240.14d-103	3235-0382
Regulation 14E	240.14e-1 thru 240.14e-2	3235-0102
Rule 14f-1	240.14f-1	3235-0108
Rule 15a-4	240.15a-4	3235-0010
Rule 15a-6	240.15a-6	3235-0371
Rule 15b1-1	240.15b1-1	3235-0012
Rule 15b6-1(a)	240.15b6-1(a)	3235-0018
Rule 15c1-5	240.15c1-5	3235-0471
Rule 15c1-6	240.15c1-6	3235-0472
Rule 15c1-7	240.15c1-7	3235-0134
Rule 15c2-1	240.15c2-1	3235-0485
Rule 15c2-5	240.15c2-5	3235-0198
Rule 15c2-7	240.15c2-7	3235-0479
Rule 15c2-8	240.15c2-8	3235-0481
Rule 15c2-11	240.15c2-11	3235-0202
Rule 15c2-12	240.15c2-12	3235-0372
Rule 15c3-1	240.15c3-1	3235-0200
Rule 15c3-1(c)(13)	240.15c3-1(c)(13)	3235-0499
Appendix F to Rule 15c3-1	240.15c3-1f	3235-0496
Rule 15c3-3	240.15c3-3	3235-0078
Rule 15c3-4	240.15c3-4	3235-0497
Rule 15d-16	240.15d-16	3235-0116
Rule 15g-2	240.15g-2	3235-0434
Rule 15g-3	240.15g-3	3235-0392
Rule 15g-4	240.15g-4	3235-0393
Rule 15g-5	240.15g-5	3235-0394
Rule 15g-6	240.15g-6	3235-0395
Rule 15g-9	240.15g-9	3235-0385
Rule 15Aj-1	240.15Aj-1	3235-0044
Rule 15Ba2-1	240.15Ba2-1	3235-0083
Rule 15Ba2-5	240.15Ba2-5	3235-0088
Rule 15Bc3-1	240.15Bc3-1	3235-0087
Rule 17a-1	240.17a-1	3235-0208
Rule 17a-2	240.17a-2	3235-0201
Rule 17a-3	240.17a-3	3235-0033
Rule 17a-3(a)(16)	240.17a-3(a)(16)	3235-0508
Rule 17a-4	240.17a-4	3235-0279
Rule 17a-4(b)(10)	240.17a-4(b)(10)	3235-0506
Rule 17a-5	240.17a-5	3235-0123
Rule 17a-5(c)	240.17a-5(c)	3235-0199
Rule 17a-6	240.17a-6	3235-0489
Rule 17a-7	240.17a-7	3235-0131
Rule 17a-8	240.17a-8	3235-0092
Rule 17a-9T	240.17a-9T	3235-0524
Rule 17a-10	240.17a-10	3235-0122
Rule 17a-11	240.17a-11	3235-0085
Rule 17a-12	240.17a-12	3235-0498
Rule 17a-13	240.17a-13	3235-0035
Rule 17a-19	240.17a-19	3235-0133
Rule 17a-22	240.17a-22	3235-0196
Rule 17a-25	240.17a-25	3235-0540
Rule 17f-1(b)	240.17f-1(b)	3235-0032
Rule 17f-1(c)	240.17f-1(c)	3235-0037
Rule 17f-1(g)	240.17f-1(g)	3235-0290
Rule 17f-2(a)	240.17f-2(a)	3235-0034
Rule 17f-2(c)	240.17f-2(c)	3235-0029
Rule 17f-2(d)	240.17f-2(d)	3235-0028
Rule 17f-2(e)	240.17f-2(e)	3235-0031
Rule 17f-5	240.17f-5	3235-0269
Rule 17h-1T	240.17h-1T	3235-0410
Rule 17h-2T	240.17h-2T	3235-0410
Rule 17Ab2-1	240.17Ab2-1(a)	3235-0195
Rule 17Ac2-1	240.17Ac2-1	3235-0084
Rule 17Ad-2(c), (d), and (h)	240.17Ad-2(c), (d) and (h)	3235-0130
Rule 17Ad-3(b)	240.17Ad-3(b)	3235-0473
Rule 17Ad-4(b) and (c)	240.17Ad-4(b) and (c)	3235-0341
Rule 17Ad-6	240.17Ad-6	3235-0291
Rule 17Ad-7	240.17Ad-7	3235-0291
Rule 17Ad-10	240.17Ad-10	3235-0273
Rule 17Ad-11	240.17Ad-11	3235-0274
Rule 17Ad-13	240.17Ad-13	3235-0275
Rule 17Ad-15	240.17Ad-15	3235-0409
Rule 17Ad-16	240.17Ad-16	3235-0413

Information collection requirement	17 CFR part or section where identified and described	Current OMB Control No.
Rule 17Ad-17	240.17Ad-17	3235-0469
Rule 19b-1	240.19b-1	3235-0354
Rule 19b-4	240.19b-4	3235-0045
Rule 19b-4(e)	240.19b-4(e)	3235-0504
Rule 19b-5	240.19b-5	3235-0507
Rule 19b-7	240.19b-7	3235-0553
Rule 19d-1	240.19d-1(b) thru 240.19d-1(i)	3235-0206
Rule 19d-2	240.19d-2	3235-0205
Rule 19d-3	240.19d-3	3235-0204
Rule 19h-1	240.19h-1(a), (c) thru (e), and (g)	3235-0259
Rule 24b-1	240.24b-1	3235-0194
Rule 101	242.101	3235-0464
Rule 102	242.102	3235-0467
Rule 103	242.103	3235-0466
Rule 104	242.104	3235-0465
Rule 301	242.301	3235-0509
Rule 302	242.302	3235-0510
Rule 303	242.303	3235-0505
Rule 604	242.604	3235-0462
Rule 605	242.605	3235-0542
Rule 606	242.606	3235-0541
Rule 607	242.607	3235-0435
Rule 608	242.608	3235-0500
Rule 609	242.609	3235-0043
Rule 611	242.611	3235-0600
Regulation S-P	Part 248	3235-0537
Form 1	249.1	3235-0017
Form 1-N	249.10	3235-0554
Form 25	249.25	3235-0080
Form 26	249.26	3235-0079
Form 3	249.103	3235-0104
Form 4	249.104	3235-0287
Form 5	249.105	3235-0362
Form 8-A	249.208a	3235-0056
Form 10	249.210	3235-0064
Form 10-SB	249.210b	3235-0419
Form 18	249.218	3235-0121
Form 20-F	249.220f	3235-0288
Form 40-F	249.240f	3235-0381
Form 6-K	249.306	3235-0116
Form 8-K	249.308	3235-0060
Form 10-Q	249.308a	3235-0070
Form 10-QSB	249.308b	3235-0416
Form 10-K	249.310	3235-0063
Form 10-KSB	249.310b	3235-0420
Form 11-K	249.311	3235-0082
Form 18-K	249.318	3235-0120
Form 12B-25	249.322	3235-0058
Form 15	249.323	3235-0167
Form 13F	249.325	3235-0006
Form SE	249.444	3235-0327
Form ET	249.445	3235-0329
Form ID	249.446	3235-0328
Form DF	249.448	3235-0482
Form BD	249.501	3235-0012
Form BDW	249.501a	3235-0018
Form BD-N	249.501b	3235-0556
Form X-17A-5	249.617	3235-0123
Form X-17A-19	249.635	3235-0133
Form ATS	249.637	3235-0509
Form ATS-R	249.638	3235-0509
Form X-15AJ-1	249.802	3235-0044
Form X-15AJ-2	249.803	3235-0044
Form 19b-4	249.819	3235-0045
Form 19b-4(e)	249.820	3235-0504
Form Pilot	249.821	3235-0507
Form SIP	249.1001	3235-0043
Form MSD	249.1100	3235-0083
Form MSDW	249.1110	3235-0087
Form X-17F-1A	249.1200	3235-0037
Form TA-1	249b.100	3235-0084
Form TA-W	249b.101	3235-0151
Form TA-2	249b.102	3235-0337

Information collection requirement	17 CFR part or section where identified and described	Current OMB Control No.
Form CA-1 .....	249b.200 .....	3235-0195
Rule 1(a) .....	250.1(a) .....	3235-0170
Rule 1(b) .....	250.1(b) .....	3235-0170
Rule 1(c) .....	250.1(c) .....	3235-0164
Rule 2 .....	250.2 .....	3235-0161
Rule 3 .....	250.3 .....	3235-0160
Rule 7 .....	250.7 .....	3235-0165
Rule 7(d) .....	250.7(d) .....	3235-0165
Rule 20(b) .....	250.20(b) .....	3235-0125
Rule 20(c) .....	250.20(c) .....	3235-0125
Rule 20(d) .....	250.20(d) .....	3235-0163
Rule 23 .....	250.23 .....	3235-0125
Rule 24 .....	250.24 .....	3235-0126
Rule 26 .....	250.26 .....	3235-0183
Rule 29 .....	250.29 .....	3235-0149
Rule 44 .....	250.44 .....	3235-0147
Rule 45 .....	250.45 .....	3235-0154
Rule 47(b) .....	250.47(b) .....	3235-0163
Rule 52 .....	250.52 .....	3235-0369
Form 53 .....	250.53 .....	3235-0426
Rule 54 .....	250.54 .....	3235-0427
Rule 57(a) .....	250.57(a) .....	3235-0428
Rule 57(b) .....	250.57(b) .....	3235-0429
Rule 58 .....	250.58 .....	3235-0457
Rule 62 .....	250.62 .....	3235-0152
Rule 71(a) .....	250.71(a) .....	3235-0173
Rule 72 .....	250.72 .....	3235-0149
Rule 83 .....	250.83 .....	3235-0181
Rule 87 .....	250.87 .....	3235-0552
Rule 88 .....	250.88 .....	3235-0182
Rule 93 .....	250.93 .....	3235-0153
Rule 94 .....	250.94 .....	3235-0153
Rule 95 .....	250.95 .....	3235-0162
Rule 100(a) .....	250.100(a) .....	3235-0125
Uniform System of Accounts for Mutual Service Companies and Subsidiary Service Companies, Public Utility Holding Company Act of 1935.	Part 256 .....	3235-0153
Preservation and Destruction of Records of Registered Public Utility Holding Companies and of Mutual and Subsidiary Service Companies.	Part 257 .....	3235-0306
Form U5A .....	259.5a .....	3235-0170
Form U5B .....	259.5b .....	3235-0170
Form U5S .....	259.5s .....	3235-0164
Form U-1 .....	259.101 .....	3235-0125
Form U-13-1 .....	259.113 .....	3235-0182
Form U-6B-2 .....	259.206 .....	3235-0163
Form U-57 .....	259.207 .....	3235-0428
Form U-9C-3 .....	259.208 .....	3235-0457
Form U-12(l)-A .....	259.212a .....	3235-0173
Form U-12(l)-B .....	259.212b .....	3235-0173
Form U-13E-1 .....	259.213 .....	3235-0162
Form U-R-1 .....	259.221 .....	3235-0152
Form U-13-60 .....	259.313 .....	3235-0153
Form U-3A-2 .....	259.402 .....	3235-0161
Form U-3A3-1 .....	259.403 .....	3235-0160
Form U-7D .....	259.404 .....	3235-0165
Form U-33-S .....	259.405 .....	3235-0429
Form ET .....	259.601 .....	3235-0329
Form ID .....	259.602 .....	3235-0328
Form SE .....	259.603 .....	3235-0327
Rule 7a-15 thru 7a-37 .....	260.7a-15 thru 260.7a-37 .....	3235-0132
Form T-1 .....	269.1 .....	3235-0110
Form T-2 .....	269.2 .....	3235-0111
Form T-3 .....	269.3 .....	3235-0105
Form T-4 .....	269.4 .....	3235-0107
Form ET .....	269.6 .....	3235-0329
Form ID .....	269.7 .....	3235-0328
Form SE .....	269.8 .....	3235-0327
Form T-6 .....	269.9 .....	3235-0391
Rule 0-1 .....	270.0-1 .....	3235-0531
Rule 2a-7 .....	270.2a-7 .....	3235-0268
Rule 2a19-1 .....	270.2a19-1 .....	3235-0332
Rule 3a-4 .....	270.3a-4 .....	3235-0459
Rule 6c-7 .....	270.6c-7 .....	3235-0276
Rule 6e-2 .....	270.6e-2 .....	3235-0177

Information collection requirement	17 CFR part or section where identified and described	Current OMB Control No.
Rule 7d-1	270.7d-1	3235-0311
Rule 7d-2	270.7d-2	3235-0527
Section 8(b) of the Investment Company Act of 1940	270.8b-1 thru 270.8b-32	3235-0176
Rule 10f-3	270.10f-3	3235-0226
Rule 11a-2	270.11a-2	3235-0272
Rule 11a-3	270.11a-3	3235-0358
Rule 12b-1	270-12b-1	3235-0212
Rule 17a-7	270.17a-7	3235-0214
Rule 17a-8	270.17a-8	3235-0235
Rule 17e-1	270.17e-1	3235-0217
Rule 17f-1	270.17f-1	3235-0222
Rule 17f-2	270.17f-2	3235-0223
Rule 17f-4	270.17f-4	3235-0225
Rule 17f-6	270.17f-6	3235-0447
Rule 17f-7	270-17f-7	3235-0529
Rule 17g-1(g)	270.17g-1(g)	3235-0213
Rule 17j-1	270.17j-1	3235-0224
Rule 18f-1	270.18f-1	3235-0211
Rule 18f-3	270.18f-3	3235-0441
Rule 19a-1	270.19a-1	3235-0216
Rule 20a-1	270-20a-1	3235-0158
Rule 22d-1	270-22d-1	3235-0310
Rule 23c-1	270.23c-1	3235-0260
Rule 23c-3	270.23c-3	3235-0422
Rule 27e-1	270.27e-1	3235-0545
Rule 30b2-1	270.30b2-1	3235-0220
Rule 30d-2	270.30d-2	3235-0494
Rule 30e-1	270.30e-1	3235-0025
Rule 31a-1	270.31a-1	3235-0178
Rule 31a-2	270.31a-2	3235-0179
Rule 32a-4	270.32a-4	3235-0530
Rule 34b-1	270.34b-1	3235-0346
Rule 35d-1	270-35d-1	3235-0548
Form N-5	274.5	3235-0169
Form N-8A	274.10	3235-0175
Form N-2	274.11a-1	3235-0026
Form N-3	274.11b	3235-0316
Form N-4	274.11c	3235-0318
Form N-8B-2	274.12	3235-0186
Form N-6F	274.15	3235-0238
Form 24F-2	274.24	3235-0456
Form N-18F-1	274.51	3235-0211
Form N-54A	274.53	3235-0237
Form N-54C	274.54	3235-0236
Form N-SAR	274.101	3235-0330
Form N-27E-1	274.127e-1	3235-0545
Form N-27F-1	274.127f-1	3235-0546
Form N-17D-1	274.200	3235-0229
Form N-23C-1	274.201	3235-0230
Form N-8F	274.218	3235-0157
Form N-17F-1	274.219	3235-0359
Form N-17F-2	274.220	3235-0360
Form N-23c-3	274.221	3235-0422
Form ET	274.401	3235-0329
Form ID	274.402	3235-0328
Form SE	274.403	3235-0327
Rule 0-2	275.0-2	3235-0240
Rule 203-3	275.203-3	3235-0538
Rule 204-2	275.204-2	3235-0278
Rule 204-3	275.204-3	3235-0047
Rule 206(3)-2	275.206(3)-2	3235-0243
Rule 206(4)-2	275.206(4)-2	3235-0241
Rule 206(4)-3	275.206(4)-3	3235-0242
Rule 206(4)-4	275.206(4)-4	3235-0345
Form ADV	279.1	3235-0049
Schedule I to Form ADV	279.1	3235-0490
Form ADV-W	279.2	3235-0313
Form ADV-H	379.3	3235-0538
Form 4-R	279.4	3235-0240
Form 5-R	279.5	3235-0240
Form 6-R	279.6	3235-0240
Form 7-R	279.7	3235-0240
Form ADV-E	279.8	3235-0361



**PART 201—RULES OF PRACTICE**

5. The authority citation for part 201 continues to read as follows:

**Authority:** 15 U.S.C. 77s, 78w, 78x, 79t, 77sss, 80a–37 and 80b–11; 5 U.S.C. 504(c)(1).

6. Section 201.101 is amended by revising paragraphs (a)(9)(vi) and (a)(9)(vii) to read as follows:

**§ 201.101 Definitions.**

(a) \* \* \*

(9) \* \* \*

(vi) By the filing, pursuant to § 242.601 of this chapter, of an application for review of an action or failure to act in connection with the implementation or operation of any effective transaction reporting plan; or

(vii) By the filing, pursuant to § 242.608 of this chapter, of an application for review of an action taken or failure to act in connection with the implementation or operation of any effective national market system plan; or

\* \* \* \* \*

**PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933**

7. The general authority citation for part 230 is revised to read as follows:

**Authority:** 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z–3, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78t, 78w, 78ll(d), 78mm, 79t, 77sss, 80a–8, 80a–24, 80a–28, 80a–29, 80a–30, and 80a–37, unless otherwise noted.

\* \* \* \* \*

8. Section 230.144 is amended by:

- a. Removing the authority citation following § 230.144; and
- b. Revising paragraph (e)(1)(iii).

The revision reads as follows:

**§ 230.144 Persons deemed not to be engaged in a distribution and therefore not underwriters.**

\* \* \* \* \*

(e) \* \* \*

(1) \* \* \*

(iii) The average weekly volume of trading in such securities reported pursuant to an *effective transaction reporting plan* or an *effective national market system plan* as those terms are defined in § 242.600 of this chapter during the four-week period specified in paragraph (e)(1)(ii) of this section.

\* \* \* \* \*

**PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

9. The general authority citation for part 240 is revised to read as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 78c, 78d, 78e, 78f, 78g,

78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78ll, 78mm, 79q, 79t, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*

10. Section 240.0–10 is amended by revising paragraph (e)(1) to read as follows:

**§ 240.0–10 Small entities under the Securities Exchange Act for purposes of the Regulatory Flexibility Act.**

\* \* \* \* \*

(e) \* \* \*

(1) Has been exempted from the reporting requirements of § 242.601 of this chapter; and

\* \* \* \* \*

11. Section 240.3a51–1 is amended by revising the introductory text of paragraphs (a) and (e) to read as follows:

**§ 240.3a51–1 Definition of “penny stock”.**

\* \* \* \* \*

(a) That is an NMS stock, as defined in § 242.600 of this chapter:

\* \* \* \* \*

(e) That is registered, or approved for registration upon notice of issuance, on a national securities exchange that makes transaction reports available pursuant to § 242.601 of this chapter, provided that:

\* \* \* \* \*

12. Section 240.3a55–1 is amended by revising paragraphs (a)(2)(ii) and (b)(2)(ii)(B) to read as follows:

**§ 240.3a55–1 Method for determining market capitalization and dollar value of average daily trading volume; application of the definition of narrow-based security index.**

(a) \* \* \*

(2) \* \* \*

(ii) The 750 securities with the largest market capitalization shall be identified from the universe of all NMS securities, as defined in § 242.600 of this chapter, that are common stock or depository shares.

(b) \* \* \*

(2) \* \* \*

(ii) \* \* \*

(B) The 675 securities with the largest dollar value of ADTV shall be identified from the universe of all NMS securities as defined in § 242.600 of this chapter that are common stock or depository shares.

\* \* \* \* \*

13. Section 240.3b–16 is amended by revising paragraph (d) to read as follows:

**§ 240.3b–16 Definitions of terms used in Section 3(a)(1) of the Act.**

\* \* \* \* \*

(d) For the purposes of this section, the terms *bid and offer* shall have the same meaning as under § 242.600 of this chapter.

\* \* \* \* \*

14. Section 240.10a–1 is amended by revising paragraphs (a)(1), (e)(5)(ii) and (e)(11) to read as follows:

**§ 240.10a–1 Short sales.**

(a)(1)(i) No person shall, for his own account or for the account of any other person, effect a short sale of any security registered on, or admitted to unlisted trading privileges on, a national securities exchange, if trades in such securities are reported pursuant to an “effective transaction reporting plan” as defined in § 242.600 of this chapter and information as to such trades is made available in accordance with such plan on a real-time basis to vendors of market transaction information:

(A) Below the price at which the last sale thereof, regular way, was reported pursuant to an effective transaction reporting plan; or

(B) At such price unless such price is above the next preceding different price at which a sale of such security, regular way, was reported pursuant to an effective transaction reporting plan.

(ii) The provisions of paragraph (a)(1)(i) of this section hereof shall not apply to transactions by any person in Nasdaq securities as defined in § 242.600 of this chapter, except for those Nasdaq securities for which transaction reports are collected, processed, and made available pursuant to the plan originally submitted to the Commission pursuant to § 240.17a–15 (subsequently amended and redesignated as § 240.11Aa3–1 and subsequently redesignated as § 242.601 of this chapter), which plan was declared effective as of May 17, 1974.

\* \* \* \* \*

(e) \* \* \*

(5) \* \* \*

(ii) Effected at a price equal to the most recent offer communicated for the security by such registered specialist, registered exchange market maker or third market maker to an exchange or a national securities association (“association”) pursuant to § 242.602 of this chapter, if such offer, when communicated, was equal to or above the last sale, regular way, reported for such security pursuant to an effective transaction reporting plan:

*Provided, however,* That any exchange, by rule, may prohibit its registered specialist and registered exchange market makers from availing themselves of the exemption afforded by this paragraph (e)(5) if that exchange

determines that such action is necessary or appropriate in its market in the public interest or for the protection of investors;

\* \* \* \* \*

(11) Any sale of a security covered by paragraph (a) of this section (except a sale to a stabilizing bid complying with § 242.104 of this chapter) by any broker or dealer, for his own account or for the account of any other person, effected at a price equal to the most recent offer communicated by such broker or dealer to an exchange or association pursuant to § 242.602 of this chapter in an amount less than or equal to the quotation size associated with such offer, if such offer, when communicated, was:

(i) Above the price at which the last sale, regular way, for such security was reported pursuant to an effective transaction reporting plan; or

(ii) At such last sale price, if such last sale price is above the next preceding different price at which a sale of such security, regular way, was reported pursuant to an effective transaction reporting plan.

\* \* \* \* \*

15. Section 240.10b-10 is amended by:

- a. Revising paragraphs (a)(2)(i)(C), (a)(2)(ii)(B) and (d)(7);
  - b. Removing paragraph (d)(8); and
  - c. Redesignating paragraphs (d)(9) and (d)(10) as paragraphs (d)(8) and (d)(9).
- The revisions read as follows:

**§ 240.10b-10 Confirmation of transactions.**

\* \* \* \* \*

- (a) \* \* \*
- (1) \* \* \*
- (i) \* \* \*

(C) For a transaction in any NMS stock as defined in § 242.600 of this chapter or a security authorized for quotation on an automated interdealer quotation system that has the characteristics set forth in section 17B of the Act (15 U.S.C. 78q-2), a statement whether payment for order flow is received by the broker or dealer for transactions in such securities and the fact that the source and nature of the compensation received in connection with the particular transaction will be furnished upon written request of the customer; *provided, however*, that brokers or dealers that do not receive payment for order flow in connection with any transaction have no disclosure obligations under this paragraph; and

\* \* \* \* \*

- (ii) \* \* \*

(B) In the case of any other transaction in an NMS stock as defined by § 242.600 of this chapter, or an equity security that

is traded on a national securities exchange and that is subject to last sale reporting, the reported trade price, the price to the customer in the transaction, and the difference, if any, between the reported trade price and the price to the customer.

\* \* \* \* \*

- (d) \* \* \*

(7) NMS stock shall have the meaning provided in § 242.600 of this chapter.

\* \* \* \* \*

16. Section 240.10b-18 is amended by revising paragraph (a)(6) to read as follows:

**§ 240.10b-18 Purchases of certain equity securities by the issuer and others.**

\* \* \* \* \*

- (a) \* \* \*

(6) *Consolidated system* means a consolidated transaction or quotation reporting system that collects and publicly disseminates on a current and continuous basis transaction or quotation information in common equity securities pursuant to an effective transaction reporting plan or an effective national market system plan (as those terms are defined in § 242.600 of this chapter).

\* \* \* \* \*

**§ 240.11Aa2-1 through 240.11Ac1-6 [Removed]**

17. The undesignated center heading preceding § 240.11Aa2-1 and §§ 240.11Aa2-1 through 240.11Ac1-6 are removed.

18. Section 240.12a-7 is amended by revising the introductory text of paragraph (a)(2) to read as follows:

**§ 240.12a-7 Exemption of stock contained in standardized market baskets from section 12(a) of the Act.**

- (a) \* \* \*
- (2) The stock is an NMS stock as defined in § 242.600 of this chapter and is either:

\* \* \* \* \*

19. Section 240.12f-1 is amended by: a. Removing the authority citation following the section;

b. Removing “and” at the end of paragraph (a)(3); and

c. Revising paragraph (a)(4).  
The revision reads as follows:

**§ 240.12f-1 Applications for permission to reinstate unlisted trading privileges.**

- (a) \* \* \*
- (4) Whether transaction information concerning such security is reported pursuant to an effective transaction reporting plan contemplated by § 242.601 of this chapter;

\* \* \* \* \*

20. Section 240.12f-2 is amended by revising paragraph (a) to read as follows:

**§ 240.12f-2 Extending unlisted trading privileges to a security that is the subject of an initial public offering.**

(a) *General provision.* A national securities exchange may extend unlisted trading privileges to a subject security when at least one transaction in the subject security has been effected on the national securities exchange upon which the security is listed and the transaction has been reported pursuant to an effective transaction reporting plan, as defined in § 242.600 of this chapter.

\* \* \* \* \*

21. Section 240.15b9-1 is amended by:

- a. Removing the authority citation following the section; and
- b. Revising paragraph (c).

The revision reads as follows:

**§ 240.15b9-1 Exemption for certain exchange members.**

\* \* \* \* \*

(c) For purposes of this section, the term *Intermarket Trading System* shall mean the intermarket communications linkage operated jointly by certain self-regulatory organizations pursuant to a plan filed with, and approved by, the Commission pursuant to § 242.608 of this chapter.

22. Section 240.15c2-11 is amended by revising paragraph (f)(5) to read as follows:

**§ 240.15c2-11 Initiation or resumption of quotations without specified information.**

\* \* \* \* \*

- (a) \* \* \*

(5) The publication or submission of a quotation respecting a Nasdaq security (as defined in § 242.600 of this chapter), and such security’s listing is not suspended, terminated, or prohibited.

\* \* \* \* \*

23. Section 240.19c-3 is amended by revising paragraph (b)(6) to read as follows:

**§ 240.19c-3 Governing off-board trading by members of national securities exchanges.**

\* \* \* \* \*

- (b) \* \* \*

(6) The term *effective transaction reporting plan* shall mean any plan approved by the Commission pursuant to § 242.601 of this chapter for collecting, processing, and making available transaction reports with respect to transactions in an equity security or class of equity securities.

24. Section 240.19c-4 is amended by revising paragraph (e)(6) to read as follows:

§ 240.19c-4 Governing certain listing or authorization determinations by national securities exchanges and associations.

\* \* \* \* \*

(e) \* \* \*
(6) The term exchange shall mean a national securities exchange, registered as such with the Securities and Exchange Commission pursuant to section 6 of the Act (15 U.S.C. 78f), which makes transaction reports available pursuant to § 242.601 of this chapter; and

\* \* \* \* \*

25. Section 240.31 is amended by revising paragraph (a)(11)(v) to read as follows:

§ 240.31 Section 31 transaction fees.

(a) Definitions. For the purpose of this section, the following definitions shall apply:

\* \* \* \* \*

(11) \* \* \*

(v) Any sale of a security that is executed outside the United States and is not reported, or required to be reported, to a transaction reporting association as defined in § 242.600 and any approved plan filed thereunder;

\* \* \* \* \*

PART 242—REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

26. The authority citation for part 242 is revised to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

27. The part heading for part 242 is revised as set forth above.

28. Section 242.100 is amended by revising the definition for "electronic communications network" and "Nasdaq" found in paragraph (b) to read as follows:

§ 242.100 Preliminary note; definitions.

\* \* \* \* \*

(b) \* \* \*

Electronic communications network has the meaning provided in § 242.600.

\* \* \* \* \*

Nasdaq means the electronic dealer quotation system owned and operated by The Nasdaq Stock Market, Inc.

\* \* \* \* \*

29. Section 242.300 is amended by:
a. Revising paragraphs (g) and (h);
b. Removing paragraphs (i) and (j); and
c. Redesignating paragraphs (k), (l), and (m) as paragraphs (i), (j), and (k).

The revisions read as follows:

§ 242.300 Definitions.

\* \* \* \* \*

(g) NMS stock shall have the meaning provided in § 242.600; provided, however, that a debt or convertible security shall not be deemed an NMS stock for purposes of this Regulation ATS.

(h) Effective transaction reporting plan shall have the meaning provided in § 242.600.

\* \* \* \* \*

30. Section 242.301 is amended by revising paragraphs (b)(3), (b)(5), and (b)(6) to read as follows:

§ 242.301 Requirements for alternative trading systems.

\* \* \* \* \*

(b) \* \* \*

(3) Order display and execution access.

(i) An alternative trading system shall comply with the requirements set forth in paragraph (b)(3)(ii) of this section, with respect to any NMS stock in which the alternative trading system:

(A) Displays subscriber orders to any person (other than alternative trading system employees); and

(B) During at least 4 of the preceding 6 calendar months, had an average daily trading volume of 5 percent or more of the aggregate average daily share volume for such NMS stock as reported by an effective transaction reporting plan.

(ii) Such alternative trading system shall provide to a national securities exchange or national securities association the prices and sizes of the orders at the highest buy price and the lowest sell price for such NMS stock, displayed to more than one person in the alternative trading system, for inclusion in the quotation data made available by the national securities exchange or national securities association to vendors pursuant to § 242.602.

(i) With respect to any order displayed pursuant to paragraph (b)(3)(ii) of this section, an alternative trading system shall provide to any broker-dealer that has access to the national securities exchange or national securities association to which the alternative trading system provides the prices and sizes of displayed orders pursuant to paragraph (b)(3)(ii) of this section, the ability to effect a transaction with such orders that is:

(A) Equivalent to the ability of such broker-dealer to effect a transaction with other orders displayed on the exchange or by the association; and

(B) At the price of the highest priced buy order or lowest priced sell order

displayed for the lesser of the cumulative size of such priced orders entered therein at such price, or the size of the execution sought by such broker-dealer.

\* \* \* \* \*

(5) Fair access.

(i) An alternative trading system shall comply with the requirements in paragraph (b)(5)(ii) of this section, if during at least 4 of the preceding 6 calendar months, such alternative trading system had:

(A) With respect to any NMS stock, 5 percent or more of the average daily volume in that security reported by an effective transaction reporting plan;

(B) With respect to an equity security that is not an NMS stock and for which transactions are reported to a self-regulatory organization, 5 percent or more of the average daily trading volume in that security as calculated by the self-regulatory organization to which such transactions are reported;

(C) With respect to municipal securities, 5 percent or more of the average daily volume traded in the United States;

(D) With respect to investment grade corporate debt, 5 percent or more of the average daily volume traded in the United States; or

(E) With respect to non-investment grade corporate debt, 5 percent or more of the average daily volume traded in the United States.

(ii) An alternative trading system shall:

(A) Establish written standards for granting access to trading on its system;

(B) Not unreasonably prohibit or limit any person in respect to access to services offered by such alternative trading system by applying the standards established under paragraph (b)(5)(ii)(A) of this section in an unfair or discriminatory manner;

(C) Make and keep records of:

(1) All grants of access including, for all subscribers, the reasons for granting such access; and

(2) All denials or limitations of access and reasons, for each applicant, for denying or limiting access; and

(D) Report the information required on Form ATS-R (§ 249.638 of this chapter) regarding grants, denials, and limitations of access.

(iii) Notwithstanding paragraph (b)(5)(i) of this section, an alternative trading system shall not be required to comply with the requirements in paragraph (b)(5)(ii) of this section, if such alternative trading system:

(A) Matches customer orders for a security with other customer orders;

(B) Such customers' orders are not displayed to any person, other than

employees of the alternative trading system; and

(C) Such orders are executed at a price for such security disseminated by an effective transaction reporting plan, or derived from such prices.

(6) *Capacity, integrity, and security of automated systems.*

(i) The alternative trading system shall comply with the requirements in paragraph (b)(6)(ii) of this section, if during at least 4 of the preceding 6 calendar months, such alternative trading system had:

(A) With respect to any NMS stock, 20 percent or more of the average daily volume reported by an effective transaction reporting plan;

(B) With respect to equity securities that are not NMS stocks and for which transactions are reported to a self-regulatory organization, 20 percent or more of the average daily volume as calculated by the self-regulatory organization to which such transactions are reported;

(C) With respect to municipal securities, 20 percent or more of the average daily volume traded in the United States;

(D) With respect to investment grade corporate debt, 20 percent or more of the average daily volume traded in the United States; or

(E) With respect to non-investment grade corporate debt, 20 percent or more of the average daily volume traded in the United States.

(i) With respect to those systems that support order entry, order routing, order execution, transaction reporting, and trade comparison, the alternative trading system shall:

(A) Establish reasonable current and future capacity estimates;

(B) Conduct periodic capacity stress tests of critical systems to determine such system's ability to process transactions in an accurate, timely, and efficient manner;

(C) Develop and implement reasonable procedures to review and keep current its system development and testing methodology;

(D) Review the vulnerability of its systems and data center computer operations to internal and external threats, physical hazards, and natural disasters;

(E) Establish adequate contingency and disaster recovery plans;

(F) On an annual basis, perform an independent review, in accordance with established audit procedures and standards, of such alternative trading system's controls for ensuring that paragraphs (b)(6)(ii)(A) through (E) of this section are met, and conduct a review by senior management of a

report containing the recommendations and conclusions of the independent review; and

(G) Promptly notify the Commission staff of material systems outages and significant systems changes.

(iii) Notwithstanding paragraph (b)(6)(i) of this section, an alternative trading system shall not be required to comply with the requirements in paragraph (b)(6)(ii) of this section, if such alternative trading system:

(A) Matches customer orders for a security with other customer orders;

(B) Such customers' orders are not displayed to any person, other than employees of the alternative trading system; and

(C) Such orders are executed at a price for such security disseminated by an effective transaction reporting plan, or derived from such prices.

\* \* \* \* \*

31. Part 242 is amended by adding Regulation NMS, §§ 242.600 through 242.612 to read as follows:  
Sec.

**Regulation NMS—Regulation of the National Market System**

242.600 NMS security designation and definitions.

242.601 Dissemination of transaction reports and last sale data with respect to transactions in NMS stocks.

242.602 Dissemination of quotations in NMS securities.

242.603 Distribution, consolidation, and display of information with respect to quotations for and transactions in NMS stocks.

242.604 Display of customer limit orders.

242.605 Disclosure of order execution information.

242.606 Disclosure of order routing information.

242.607 Customer account statements.

242.608 Filing and amendment of national market system plans.

242.609 Registration of securities information processors: form of application and amendments.

242.610 Access to quotations.

242.611 Order protection rule.

242.612 Minimum pricing increment.

**Regulation NMS—Regulation of the National Market System**

**§ 242.600 NMS security designation and definitions.**

(a) The term *national market system security* as used in section 11A(a)(2) of the Act (15 U.S.C. 78k-1(a)(2)) shall mean any NMS security as defined in paragraph (b) of this section.

(b) For purposes of Regulation NMS (§§ 242.600 through 242.612), the following definitions shall apply:

(1) *Aggregate quotation size* means the sum of the quotation sizes of all responsible brokers or dealers who have

communicated on any national securities exchange bids or offers for an NMS security at the same price.

(2) *Alternative trading system* has the meaning provided in § 242.300(a).

(3) *Automated quotation* means a quotation displayed by a trading center that:

(i) Permits an incoming order to be marked as immediate-or-cancel;

(ii) Immediately and automatically executes an order marked as immediate-or-cancel against the displayed quotation up to its full size;

(iii) Immediately and automatically cancels any unexecuted portion of an order marked as immediate-or-cancel without routing the order elsewhere;

(iv) Immediately and automatically transmits a response to the sender of an order marked as immediate-or-cancel indicating the action taken with respect to such order; and

(v) Immediately and automatically displays information that updates the displayed quotation to reflect any change to its material terms.

(4) *Automated trading center* means a trading center that:

(i) Has implemented such systems and rules as are necessary to render it capable of displaying quotations that meet the requirements for an automated quotation set forth in paragraph (b)(3) of this section;

(ii) Identifies all quotations other than automated quotations as manual quotations;

(iii) Immediately identifies its quotations as manual quotations whenever it has reason to believe that it is not capable of displaying automated quotations; and

(iv) Has adopted reasonable standards limiting when its quotations change from automated quotations to manual quotations, and vice versa, to specifically defined circumstances that promote fair and efficient access to its automated quotations and are consistent with the maintenance of fair and orderly markets.

(5) *Average effective spread* means the share-weighted average of effective spreads for order executions calculated, for buy orders, as double the amount of difference between the execution price and the midpoint of the national best bid and national best offer at the time of order receipt and, for sell orders, as double the amount of difference between the midpoint of the national best bid and national best offer at the time of order receipt and the execution price.

(6) *Average realized spread* means the share-weighted average of realized spreads for order executions calculated, for buy orders, as double the amount of

difference between the execution price and the midpoint of the national best bid and national best offer five minutes after the time of order execution and, for sell orders, as double the amount of difference between the midpoint of the national best bid and national best offer five minutes after the time of order execution and the execution price; *provided, however*, that the midpoint of the final national best bid and national best offer disseminated for regular trading hours shall be used to calculate a realized spread if it is disseminated less than five minutes after the time of order execution.

(7) *Best bid and best offer* mean the highest priced bid and the lowest priced offer.

(8) *Bid or offer* means the bid price or the offer price communicated by a member of a national securities exchange or member of a national securities association to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of an NMS security, as either principal or agent, but shall not include indications of interest.

(9) *Block size with respect to* an order means it is:

(i) Of at least 10,000 shares; or

(ii) For a quantity of stock having a market value of at least \$200,000.

(10) *Categorized by order size* means dividing orders into separate categories for sizes from 100 to 499 shares, from 500 to 1999 shares, from 2000 to 4999 shares, and 5000 or greater shares.

(11) *Categorized by order type* means dividing orders into separate categories for market orders, marketable limit orders, inside-the-quote limit orders, at-the-quote limit orders, and near-the-quote limit orders.

(12) *Categorized by security* means dividing orders into separate categories for each NMS stock that is included in a report.

(13) *Consolidated display* means:

(i) The prices, sizes, and market identifications of the national best bid and national best offer for a security; and

(ii) Consolidated last sale information for a security.

(14) *Consolidated last sale information* means the price, volume, and market identification of the most recent transaction report for a security that is disseminated pursuant to an effective national market system plan.

(15) *Covered order* means any market order or any limit order (including immediate-or-cancel orders) received by a market center during regular trading hours at a time when a national best bid and national best offer is being disseminated, and, if executed, is

executed during regular trading hours, but shall exclude any order for which the customer requests special handling for execution, including, but not limited to, orders to be executed at a market opening price or a market closing price, orders submitted with stop prices, orders to be executed only at their full size, orders to be executed on a particular type of tick or bid, orders submitted on a "not held" basis, orders for other than regular settlement, and orders to be executed at prices unrelated to the market price of the security at the time of execution.

(16) *Customer* means any person that is not a broker or dealer.

(17) *Customer limit order* means an order to buy or sell an NMS stock at a specified price that is not for the account of either a broker or dealer; *provided, however*, that the term *customer limit order* shall include an order transmitted by a broker or dealer on behalf of a customer.

(18) *Customer order* means an order to buy or sell an NMS security that is not for the account of a broker or dealer, but shall not include any order for a quantity of a security having a market value of at least \$50,000 for an NMS security that is an option contract and a market value of at least \$200,000 for any other NMS security.

(19) *Directed order* means a customer order that the customer specifically instructed the broker or dealer to route to a particular venue for execution.

(20) *Dynamic market monitoring device* means any service provided by a vendor on an interrogation device or other display that:

(i) Permits real-time monitoring, on a dynamic basis, of transaction reports, last sale data, or quotation information with respect to a particular security; and

(ii) Displays the most recent transaction report, last sale data, or quotation information with respect to that security until such report, data, or information has been superseded or supplemented by the display of a new transaction report, last sale data, or quotation information reflecting the next reported transaction or quotation in that security.

(21) *Effective national market system plan* means any national market system plan approved by the Commission (either temporarily or on a permanent basis) pursuant to § 242.608.

(22) *Effective transaction reporting plan* means any transaction reporting plan approved by the Commission pursuant to § 242.601.

(23) *Electronic communications network* means any electronic system that widely disseminates to third parties orders entered therein by an exchange

market maker or OTC market maker, and permits such orders to be executed against in whole or in part; except that the term *electronic communications network* shall not include:

(i) Any system that crosses multiple orders at one or more specified times at a single price set by the system (by algorithm or by any derivative pricing mechanism) and does not allow orders to be crossed or executed against directly by participants outside of such times; or

(ii) Any system operated by, or on behalf of, an OTC market maker or exchange market maker that executes customer orders primarily against the account of such market maker as principal, other than riskless principal.

(24) *Exchange market maker* means any member of a national securities exchange that is registered as a specialist or market maker pursuant to the rules of such exchange.

(25) *Exchange-traded security* means any NMS security or class of NMS securities listed and registered, or admitted to unlisted trading privileges, on a national securities exchange; *provided, however*, that securities not listed on any national securities exchange that are traded pursuant to unlisted trading privileges are excluded.

(26) *Executed at the quote* means, for buy orders, execution at a price equal to the national best offer at the time of order receipt and, for sell orders, execution at a price equal to the national best bid at the time of order receipt.

(27) *Executed outside the quote* means, for buy orders, execution at a price higher than the national best offer at the time of order receipt and, for sell orders, execution at a price lower than the national best bid at the time of order receipt.

(28) *Executed with price improvement* means, for buy orders, execution at a price lower than the national best offer at the time of order receipt and, for sell orders, execution at a price higher than the national best bid at the time of order receipt.

(29) *Inside-the-quote limit order, at-the-quote limit order, and near-the-quote limit order* mean non-marketable buy orders with limit prices that are, respectively, higher than, equal to, and lower by \$0.10 or less than the national best bid at the time of order receipt, and non-marketable sell orders with limit prices that are, respectively, lower than, equal to, and higher by \$0.10 or less than the national best offer at the time of order receipt.

(30) *Intermarket sweep order* means a limit order for an NMS stock that meets the following requirements:

(i) When routed to a trading center, the limit order is identified as an intermarket sweep order; and

(ii) Simultaneously with the routing of the limit order identified as an intermarket sweep order, one or more additional limit orders, as necessary, are routed to execute against the full displayed size of any protected bid, in the case of a limit order to sell, or the full displayed size of any protected offer, in the case of a limit order to buy, for the NMS stock with a price that is superior to the limit price of the limit order identified as an intermarket sweep order. These additional routed orders also must be marked as intermarket sweep orders.

(31) *Interrogation device* means any securities information retrieval system capable of displaying transaction reports, last sale data, or quotation information upon inquiry, on a current basis on a terminal or other device.

(32) *Joint self-regulatory organization plan* means a plan as to which two or more self-regulatory organizations, acting jointly, are sponsors.

(33) *Last sale data* means any price or volume data associated with a transaction.

(34) *Listed equity security* means any equity security listed and registered, or admitted to unlisted trading privileges, on a national securities exchange.

(35) *Listed option* means any option traded on a registered national securities exchange or automated facility of a national securities association.

(36) *Make publicly available* means posting on an Internet Web site that is free and readily accessible to the public, furnishing a written copy to customers on request without charge, and notifying customers at least annually in writing that a written copy will be furnished on request.

(37) *Manual quotation* means any quotation other than an automated quotation.

(38) *Market center* means any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association.

(39) *Marketable limit order* means any buy order with a limit price equal to or greater than the national best offer at the time of order receipt, or any sell order with a limit price equal to or less than the national best bid at the time of order receipt.

(40) *Moving ticker* means any continuous real-time moving display of transaction reports or last sale data (other than a dynamic market monitoring device) provided on an interrogation or other display device.

(41) *Nasdaq security* means any registered security listed on The Nasdaq Stock Market, Inc.

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

(43) *National market system plan* means any joint self-regulatory organization plan in connection with:

(i) The planning, development, operation or regulation of a national market system (or a subsystem thereof) or one or more facilities thereof; or

(ii) The development and implementation of procedures and/or facilities designed to achieve compliance by self-regulatory organizations and their members with any section of this Regulation NMS and part 240, subpart A of this chapter promulgated pursuant to section 11A of the Act (15 U.S.C. 78k-1).

(44) *National securities association* means any association of brokers and dealers registered pursuant to section 15A of the Act (15 U.S.C. 78o-3).

(45) *National securities exchange* means any exchange registered pursuant to section 6 of the Act (15 U.S.C. 78f).

(46) *NMS security* means any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.

(47) *NMS stock* means any NMS security other than an option.

(48) *Non-directed order* means any customer order other than a directed order.

(49) *Odd-lot* means an order for the purchase or sale of an NMS stock in an amount less than a round lot.

(50) *Options class* means all of the put option or call option series overlying a security, as defined in section 3(a)(10) of the Act (15 U.S.C. 78c(a)(10)).

(51) *Options series* means the contracts in an options class that have the same unit of trade, expiration date,

and exercise price, and other terms or conditions.

(52) *OTC market maker* means any dealer that holds itself out as being willing to buy from and sell to its customers, or others, in the United States, an NMS stock for its own account on a regular or continuous basis otherwise than on a national securities exchange in amounts of less than block size.

(53) *Participants*, when used in connection with a national market system plan, means any self-regulatory organization which has agreed to act in accordance with the terms of the plan but which is not a signatory of such plan.

(54) *Payment for order flow* has the meaning provided in § 240.10b-10 of this chapter.

(55) *Plan processor* means any self-regulatory organization or securities information processor acting as an exclusive processor in connection with the development, implementation and/or operation of any facility contemplated by an effective national market system plan.

(56) *Profit-sharing relationship* means any ownership or other type of affiliation under which the broker or dealer, directly or indirectly, may share in any profits that may be derived from the execution of non-directed orders.

#### Alternative A

##### *Proposed Market BBO Alternative for Paragraph (b)(57) of This Section*

(57) *Protected bid or protected offer* means a quotation in an NMS stock that:

(i) Is displayed by an automated trading center;

(ii) Is disseminated pursuant to an effective national market system plan; and

(iii) Is an automated quotation that is the best bid or best offer of a national securities exchange, the best bid or best offer of The Nasdaq Stock Market, Inc., or the best bid or best offer of a national securities association other than the best bid or best offer of The Nasdaq Stock Market, Inc.

#### Alternative B

##### *Proposed Voluntary Depth Alternative for Paragraph (b)(57) of This Section*

(57) *Protected bid or protected offer* means a quotation in an NMS stock that:

(i) Is displayed by an automated trading center;

(ii) Is disseminated pursuant to an effective national market system plan; and

(iii) Is an automated quotation that is the best bid or best offer of a national securities exchange, the best bid or best

offer of The Nasdaq Stock Market, Inc., or the best bid or best offer of a national securities association other than the best bid or best offer of The Nasdaq Stock Market, Inc., or such additional bids or offers that are designated as protected bids or protected offers pursuant to an effective national market system plan.

(58) *Protected quotation* means a protected bid or a protected offer.

(59) *Published aggregate quotation size* means the aggregate quotation size calculated by a national securities exchange and displayed by a vendor on a terminal or other display device at the time an order is presented for execution to a responsible broker or dealer.

(60) *Published bid and published offer* means the bid or offer of a responsible broker or dealer for an NMS security communicated by it to its national securities exchange or association pursuant to § 242.602 and displayed by a vendor on a terminal or other display device at the time an order is presented for execution to such responsible broker or dealer.

(61) *Published quotation size* means the quotation size of a responsible broker or dealer communicated by it to its national securities exchange or association pursuant to § 242.602 and displayed by a vendor on a terminal or other display device at the time an order is presented for execution to such responsible broker or dealer.

(62) *Quotation size*, when used with respect to a responsible broker's or dealer's bid or offer for an NMS security, means:

(i) The number of shares (or units of trading) of that security which such responsible broker or dealer has specified, for purposes of dissemination to vendors, that it is willing to buy at the bid price or sell at the offer price comprising its bid or offer, as either principal or agent; or

(ii) In the event such responsible broker or dealer has not so specified, a normal unit of trading for that NMS security.

(63) *Quotations and quotation information* mean bids, offers and, where applicable, quotation sizes and aggregate quotation sizes.

(64) *Regular trading hours* means the time between 9:30 a.m. and 4:00 p.m. Eastern Time, or such other time as is set forth in the procedures established pursuant to § 242.605(a)(2).

(65) *Responsible broker or dealer* means:

(i) When used with respect to bids or offers communicated on a national securities exchange, any member of such national securities exchange who communicates to another member on such national securities exchange, at the

location (or locations) or through the facility or facilities designated by such national securities exchange for trading in an NMS security a bid or offer for such NMS security, as either principal or agent; *provided, however*, that, in the event two or more members of a national securities exchange have communicated on or through such national securities exchange bids or offers for an NMS security at the same price, each such member shall be considered a *responsible broker or dealer* for that bid or offer, subject to the rules of priority and precedence then in effect on that national securities exchange; and further *provided*, that for a bid or offer which is transmitted from one member of a national securities exchange to another member who undertakes to represent such bid or offer on such national securities exchange as agent, only the last member who undertakes to represent such bid or offer as agent shall be considered the *responsible broker or dealer* for that bid or offer; and

(ii) When used with respect to bids and offers communicated by an OTC market maker to a broker or dealer or a customer, the OTC market maker communicating the bid or offer (regardless of whether such bid or offer is for its own account or on behalf of another person).

(66) *Revised bid or offer* means a market maker's bid or offer which supersedes its published bid or published offer.

(67) *Revised quotation size* means a market maker's quotation size which supersedes its published quotation size.

(68) *Self-regulatory organization* means any national securities exchange or national securities association.

(69) *Specified persons*, when used in connection with any notification required to be provided pursuant to § 242.602(a)(3) and any election (or withdrawal thereof) permitted under § 242.602(a)(5), means:

(i) Each vendor;

(ii) Each plan processor; and

(iii) The processor for the Options Price Reporting Authority (in the case of a notification for a subject security which is a class of securities underlying options admitted to trading on any national securities exchange).

(70) *Sponsor*, when used in connection with a national market system plan, means any self-regulatory organization which is a signatory to such plan and has agreed to act in accordance with the terms of the plan.

(71) *SRO display-only facility* means a facility operated by a national securities exchange or national securities association that displays quotations in a

security, but does not execute orders against such quotations or present orders for execution.

(72) *SRO trading facility* means a facility operated by a national securities exchange or a national securities association that executes orders in a security or presents orders to members for execution.

(73) *Subject security* means:

(i) With respect to a national securities exchange:

(A) Any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported pursuant to an effective transaction reporting plan or effective national market system plan; and

(B) Any other NMS security for which such exchange has in effect an election, pursuant to § 242.602(a)(5)(i), to collect, process, and make available to a vendor bids, offers, quotation sizes, and aggregate quotation sizes communicated on such exchange; and

(ii) With respect to a member of a national securities association:

(A) Any exchange-traded security for which such member acts in the capacity of an OTC market maker unless the executed volume of such member, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported pursuant to an effective transaction reporting plan or effective national market system plan; and

(B) Any other NMS security for which such member acts in the capacity of an OTC market maker and has in effect an election, pursuant to § 242.602(a)(5)(ii), to communicate to its association bids, offers, and quotation sizes for the purpose of making such bids, offers, and quotation sizes available to a vendor.

(74) *Time of order execution* means the time (to the second) that an order was executed at any venue.

(75) *Time of order receipt* means the time (to the second) that an order was received by a market center for execution.

(76) *Time of the transaction* has the meaning provided in § 240.10b-10 of this chapter.

(77) *Trade-through* means the purchase or sale of an NMS stock during regular trading hours, either as principal or agent, at a price that is lower than a protected bid or higher than a protected offer.

(78) *Trading center* means a national securities exchange or national securities association that operates an

SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.

(79) *Trading rotation* means, with respect to an options class, the time period on a national securities exchange during which:

(i) Opening, re-opening, or closing transactions in options series in such options class are not yet completed; and

(ii) Continuous trading has not yet commenced or has not yet ended for the day in options series in such options class.

(80) *Transaction report* means a report containing the price and volume associated with a transaction involving the purchase or sale of one or more round lots of a security.

(81) *Transaction reporting association* means any person authorized to implement or administer any transaction reporting plan on behalf of persons acting jointly under § 242.601(a).

(82) *Transaction reporting plan* means any plan for collecting, processing, making available or disseminating transaction reports with respect to transactions in NMS stocks filed with the Commission pursuant to, and meeting the requirements of, § 242.601.

(83) *Vendor* means any securities information processor engaged in the business of disseminating transaction reports, last sale data, or quotation information with respect to NMS securities to brokers, dealers, or investors on a real-time or other current and continuing basis, whether through an electronic communications network, moving ticker, or interrogation device.

**§ 242.601 Dissemination of transaction reports and last sale data with respect to transactions in NMS stocks.**

(a)(1) Every national securities exchange shall file a transaction reporting plan regarding transactions in listed equity and Nasdaq securities executed through its facilities, and every national securities association shall file a transaction reporting plan regarding transactions in listed equity and Nasdaq securities executed by its members otherwise than on a national securities exchange.

(2) Any transaction reporting plan, or any amendment thereto, filed pursuant to this section shall be filed with the Commission, and considered for approval, in accordance with the procedures set forth in § 242.608(a) and (b). Any such plan, or amendment thereto, shall specify, at a minimum:

(i) The listed equity and Nasdaq securities or classes of such securities for which transaction reports shall be required by the plan;

(ii) Reporting requirements with respect to transactions in listed equity securities and Nasdaq securities, for any broker or dealer subject to the plan;

(iii) The manner of collecting, processing, sequencing, making available and disseminating transaction reports and last sale data reported pursuant to such plan;

(iv) The manner in which such transaction reports reported pursuant to such plan are to be consolidated with transaction reports from national securities exchanges and national securities associations reported pursuant to any other effective transaction reporting plan;

(v) The applicable standards and methods which will be utilized to ensure promptness of reporting, and accuracy and completeness of transaction reports;

(vi) Any rules or procedures which may be adopted to ensure that transaction reports or last sale data will not be disseminated in a fraudulent or manipulative manner;

(vii) Specific terms of access to transaction reports made available or disseminated pursuant to the plan; and

(viii) That transaction reports or last sale data made available to any vendor for display on an interrogation device identify the marketplace where each transaction was executed.

(3) No transaction reporting plan filed pursuant to this section, or any amendment to an effective transaction reporting plan, shall become effective unless approved by the Commission or otherwise permitted in accordance with the procedures set forth in § 242.608.

(b) *Prohibitions and reporting requirements.*

(1) No broker or dealer may execute any transaction in, or induce or attempt to induce the purchase or sale of, any NMS stock:

(i) On or through the facilities of a national securities exchange unless there is an effective transaction reporting plan with respect to transactions in such security executed on or through such exchange facilities; or

(ii) Otherwise than on a national securities exchange unless there is an effective transaction reporting plan with respect to transactions in such security executed otherwise than on a national securities exchange by such broker or dealer.

(2) Every broker or dealer who is a member of a national securities exchange or national securities

association shall promptly transmit to the exchange or association of which it is a member all information required by any effective transaction reporting plan filed by such exchange or association (either individually or jointly with other exchanges and/or associations).

(c) *Retransmission of transaction reports or last sale data.*

Notwithstanding any provision of any effective transaction reporting plan, no national securities exchange or national securities association may, either individually or jointly, by rule, stated policy or practice, transaction reporting plan or otherwise, prohibit, condition or otherwise limit, directly or indirectly, the ability of any vendor to retransmit, for display in moving tickers, transaction reports or last sale data made available pursuant to any effective transaction reporting plan; *provided, however,* that a national securities exchange or national securities association may, by means of an effective transaction reporting plan, condition such retransmission upon appropriate undertakings to ensure that any charges for the distribution of transaction reports or last sale data in moving tickers permitted by paragraph (d) of this section are collected.

(d) *Charges.* Nothing in this section shall preclude any national securities exchange or national securities association, separately or jointly, pursuant to the terms of an effective transaction reporting plan, from imposing reasonable, uniform charges (irrespective of geographic location) for distribution of transaction reports or last sale data.

(e) *Appeals.* The Commission may, in its discretion, entertain appeals in connection with the implementation or operation of any effective transaction reporting plan in accordance with the provisions of § 242.608(d).

(f) *Exemptions.* The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any national securities exchange, national securities association, broker, dealer, or specified security if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to, and perfection of the mechanisms of, a national market system.

**§ 242.602 Dissemination of quotations in NMS securities.**

(a) *Dissemination requirements for national securities exchanges and national securities associations.*

(1) Every national securities exchange and national securities association shall



establish and maintain procedures and mechanisms for collecting bids, offers, quotation sizes, and aggregate quotation sizes from responsible brokers or dealers who are members of such exchange or association, processing such bids, offers, and sizes, and making such bids, offers, and sizes available to vendors, as follows:

(i) Each national securities exchange shall at all times such exchange is open for trading, collect, process, and make available to vendors the best bid, the best offer, and aggregate quotation sizes for each subject security listed or admitted to unlisted trading privileges which is communicated on any national securities exchange by any responsible broker or dealer, but shall not include:

(A) Any bid or offer executed immediately after communication and any bid or offer communicated by a responsible broker or dealer other than an exchange market maker which is cancelled or withdrawn if not executed immediately after communication; and

(B) Any bid or offer communicated during a period when trading in that security has been suspended or halted, or prior to the commencement of trading in that security on any trading day, on that exchange.

(ii) Each national securities association shall, at all times that last sale information with respect to NMS securities is reported pursuant to an effective transaction reporting plan, collect, process, and make available to vendors the best bid, best offer, and quotation sizes communicated otherwise than on an exchange by each member of such association acting in the capacity of an OTC market maker for each subject security and the identity of that member (excluding any bid or offer executed immediately after communication), except during any period when over-the-counter trading in that security has been suspended.

(2) Each national securities exchange shall, with respect to each published bid and published offer representing a bid or offer of a member for a subject security, establish and maintain procedures for ascertaining and disclosing to other members of that exchange, upon presentation of orders sought to be executed by them in reliance upon paragraph (b)(2) of this section, the identity of the responsible broker or dealer who made such bid or offer and the quotation size associated with it.

(3)(i) If, at any time a national securities exchange is open for trading, such exchange determines, pursuant to rules approved by the Commission pursuant to section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)), that the level of

trading activities or the existence of unusual market conditions is such that the exchange is incapable of collecting, processing, and making available to vendors the data for a subject security required to be made available pursuant to paragraph (a)(1) of this section in a manner that accurately reflects the current state of the market on such exchange, such exchange shall immediately notify all specified persons of that determination. Upon such notification, responsible brokers or dealers that are members of that exchange shall be relieved of their obligation under paragraphs (b)(2) and (c)(3) of this section and such exchange shall be relieved of its obligations under paragraphs (a)(1) and (2) of this section for that security; *provided, however*, that such exchange will continue, to the maximum extent practicable under the circumstances, to collect, process, and make available to vendors data for that security in accordance with paragraph (a)(1) of this section.

(ii) During any period a national securities exchange, or any responsible broker or dealer that is a member of that exchange, is relieved of any obligation imposed by this section for any subject security by virtue of a notification made pursuant to paragraph (a)(3)(i) of this section, such exchange shall monitor the activity or conditions which formed the basis for such notification and shall immediately renotify all specified persons when that exchange is once again capable of collecting, processing, and making available to vendors the data for that security required to be made available pursuant to paragraph (a)(1) of this section in a manner that accurately reflects the current state of the market on such exchange. Upon such renotification, any exchange or responsible broker or dealer which had been relieved of any obligation imposed by this section as a consequence of the prior notification shall again be subject to such obligation.

(4) Nothing in this section shall preclude any national securities exchange or national securities association from making available to vendors indications of interest or bids and offers for a subject security at any time such exchange or association is not required to do so pursuant to paragraph (a)(1) of this section.

(5)(i) Any national securities exchange may make an election for purposes of the definition of *subject security* in § 242.600(b)(73) for any NMS security, by collecting, processing, and making available bids, offers, quotation sizes, and aggregate quotation sizes in that security; except that for any NMS security previously listed or admitted to

unlisted trading privileges on only one exchange and not traded by any OTC market maker, such election shall be made by notifying all specified persons, and shall be effective at the opening of trading on the business day following notification.

(ii) Any member of a national securities association acting in the capacity of an OTC market maker may make an election for purposes of the definition of *subject security* in § 242.600(b)(73) for any NMS security, by communicating to its association bids, offers, and quotation sizes in that security; except that for any other NMS security listed or admitted to unlisted trading privileges on only one exchange and not traded by any other OTC market maker, such election shall be made by notifying its association and all specified persons, and shall be effective at the opening of trading on the business day following notification.

(iii) The election of a national securities exchange or member of a national securities association for any NMS security pursuant to this paragraph (a)(5) shall cease to be in effect if such exchange or member ceases to make available or communicate bids, offers, and quotation sizes in such security.

(b) *Obligations of responsible brokers and dealers.*

(1) Each responsible broker or dealer shall promptly communicate to its national securities exchange or national securities association, pursuant to the procedures established by that exchange or association, its best bids, best offers, and quotation sizes for any subject security.

(2) Subject to the provisions of paragraph (b)(3) of this section, each responsible broker or dealer shall be obligated to execute any order to buy or sell a subject security, other than an odd-lot order, presented to it by another broker or dealer, or any other person belonging to a category of persons with whom such responsible broker or dealer customarily deals, at a price at least as favorable to such buyer or seller as the responsible broker's or dealer's published bid or published offer (exclusive of any commission, commission equivalent or differential customarily charged by such responsible broker or dealer in connection with execution of any such order) in any amount up to its published quotation size.

(3)(i) No responsible broker or dealer shall be obligated to execute a transaction for any subject security as provided in paragraph (b)(2) of this section to purchase or sell that subject

security in an amount greater than such revised quotation if:

(A) Prior to the presentation of an order for the purchase or sale of a subject security, a responsible broker or dealer has communicated to its exchange or association, pursuant to paragraph (b)(1) of this section, a revised quotation size; or

(B) At the time an order for the purchase or sale of a subject security is presented, a responsible broker or dealer is in the process of effecting a transaction in such subject security, and immediately after the completion of such transaction, it communicates to its exchange or association a revised quotation size, such responsible broker or dealer shall not be obligated by paragraph (b)(2) of this section to purchase or sell that subject security in an amount greater than such revised quotation size.

(ii) No responsible broker or dealer shall be obligated to execute a transaction for any subject security as provided in paragraph (b)(2) of this section if:

(A) Before the order sought to be executed is presented, such responsible broker or dealer has communicated to its exchange or association pursuant to paragraph (b)(1) of this section, a revised bid or offer; or

(B) At the time the order sought to be executed is presented, such responsible broker or dealer is in the process of effecting a transaction in such subject security, and, immediately after the completion of such transaction, such responsible broker or dealer communicates to its exchange or association pursuant to paragraph (b)(1) of this section, a revised bid or offer; *provided, however*, that such responsible broker or dealer shall nonetheless be obligated to execute any such order in such subject security as provided in paragraph (b)(2) of this section at its revised bid or offer in any amount up to its published quotation size or revised quotation size.

(4) Subject to the provisions of paragraph (a)(4) of this section:

(i) No national securities exchange or OTC market maker may make available, disseminate or otherwise communicate to any vendor, directly or indirectly, for display on a terminal or other display device any bid, offer, quotation size, or aggregate quotation size for any NMS security which is not a subject security with respect to such exchange or OTC market maker; and

(ii) No vendor may disseminate or display on a terminal or other display device any bid, offer, quotation size, or aggregate quotation size from any national securities exchange or OTC

market maker for any NMS security which is not a subject security with respect to such exchange or OTC market maker.

(5)(i) Entry of any priced order for an NMS security by an exchange market maker or OTC market maker in that security into an electronic communications network that widely disseminates such order shall be deemed to be:

(A) A bid or offer under this section, to be communicated to the market maker's exchange or association pursuant to this paragraph (b) for at least the minimum quotation size that is required by the rules of the market maker's exchange or association if the priced order is for the account of a market maker, or the actual size of the order up to the minimum quotation size required if the priced order is for the account of a customer; and

(B) A communication of a bid or offer to a vendor for display on a display device for purposes of paragraph (b)(4) of this section.

(ii) An exchange market maker or OTC market maker that has entered a priced order for an NMS security into an electronic communications network that widely disseminates such order shall be deemed to be in compliance with paragraph (b)(5)(i)(A) of this section if the electronic communications network:

(A)(1) Provides to a national securities exchange or national securities association (or an exclusive processor acting on behalf of one or more exchanges or associations) the prices and sizes of the orders at the highest buy price and the lowest sell price for such security entered in, and widely disseminated by, the electronic communications network by exchange market makers and OTC market makers for the NMS security, and such prices and sizes are included in the quotation data made available by such exchange, association, or exclusive processor to vendors pursuant to this section; and

(2) Provides, to any broker or dealer, the ability to effect a transaction with a priced order widely disseminated by the electronic communications network entered therein by an exchange market maker or OTC market maker that is:

(i) Equivalent to the ability of any broker or dealer to effect a transaction with an exchange market maker or OTC market maker pursuant to the rules of the national securities exchange or national securities association to which the electronic communications network supplies such bids and offers; and

(ii) At the price of the highest priced buy order or lowest priced sell order, or better, for the lesser of the cumulative size of such priced orders entered

therein by exchange market makers or OTC market makers at such price, or the size of the execution sought by the broker or dealer, for such security; or

(B) Is an alternative trading system that:

(1) Displays orders and provides the ability to effect transactions with such orders under § 242.301(b)(3); and

(2) Otherwise is in compliance with Regulation ATS (§ 242.300 through § 242.303).

(c) *Transactions in listed options.*

(1) A national securities exchange or national securities association:

(i) Shall not be required, under paragraph (a) of this section, to collect from responsible brokers or dealers who are members of such exchange or association, or to make available to vendors, the quotation sizes and aggregate quotation sizes for listed options, if such exchange or association establishes by rule and periodically publishes the quotation size for which such responsible brokers or dealers are obligated to execute an order to buy or sell an options series that is a subject security at its published bid or offer under paragraph (b)(2) of this section;

(ii) May establish by rule and periodically publish a quotation size, which shall not be for less than one contract, for which responsible brokers or dealers who are members of such exchange or association are obligated under paragraph (b)(2) of this section to execute an order to buy or sell a listed option for the account of a broker or dealer that is in an amount different from the quotation size for which it is obligated to execute an order for the account of a customer; and

(iii) May establish and maintain procedures and mechanisms for collecting from responsible brokers and dealers who are members of such exchange or association, and making available to vendors, the quotation sizes and aggregate quotation sizes in listed options for which such responsible broker or dealer will be obligated under paragraph (b)(2) of this section to execute an order from a customer to buy or sell a listed option and establish by rule and periodically publish the size, which shall not be less than one contract, for which such responsible brokers or dealers are obligated to execute an order for the account of a broker or dealer.

(2) If, pursuant to paragraph (c)(1) of this section, the rules of a national securities exchange or national securities association do not require its members to communicate to it their quotation sizes for listed options, a responsible broker or dealer that is a

member of such exchange or association shall:

(i) Be relieved of its obligations under paragraph (b)(1) of this section to communicate to such exchange or association its quotation sizes for any listed option; and

(ii) Comply with its obligations under paragraph (b)(2) of this section by executing any order to buy or sell a listed option, in an amount up to the size established by such exchange's or association's rules under paragraph (c)(1) of this section.

(3) *Thirty second response.* Each responsible broker or dealer, within thirty seconds of receiving an order to buy or sell a listed option in an amount greater than the quotation size established by a national securities exchange's or national securities association's rules pursuant to paragraph (c)(1) of this section, or its published quotation size must:

(i) Execute the entire order; or

(ii)(A) Execute that portion of the order equal to at least:

(1) The quotation size established by a national securities exchange's or national securities association's rules, pursuant to paragraph (c)(1) of this section, to the extent that such exchange or association does not collect and make available to vendors quotation size and aggregate quotation size under paragraph (a) of this section; or

(2) Its published quotation size; and

(B) Revise its bid or offer.

(4) Notwithstanding paragraph (c)(3) of this section, no responsible broker or dealer shall be obligated to execute a transaction for any listed option as provided in paragraph (b)(2) of this section if:

(i) Any of the circumstances in paragraph (b)(3) of this section exist; or

(ii) The order for the purchase or sale of a listed option is presented during a trading rotation in that listed option.

(d) *Exemptions.* The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any responsible broker or dealer, electronic communications network, national securities exchange, or national securities association if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system.

**§ 242.603 Distribution, consolidation, and display of information with respect to quotations for and transactions in NMS stocks.**

(a) *Distribution of information.*

(1) Any exclusive processor, or any broker or dealer with respect to

information for which it is the exclusive source, that distributes information with respect to quotations for or transactions in an NMS stock to a securities information processor shall do so on terms that are fair and reasonable.

(2) Any national securities exchange, national securities association, broker, or dealer that distributes information with respect to quotations for or transactions in an NMS stock to a securities information processor, broker, dealer, or other persons shall do so on terms that are not unreasonably discriminatory.

(b) *Consolidation of information.*

Every national securities exchange on which an NMS stock is traded and national securities association shall act jointly pursuant to one or more effective national market system plans to disseminate consolidated information, including a national best bid and national best offer, on quotations for and transactions in NMS stocks. Such plan or plans shall provide for the dissemination of all consolidated information for an individual NMS stock through a single plan processor.

(c) *Display of information.*

(1) No securities information processor, broker, or dealer shall provide, in a context in which a trading or order-routing decision can be implemented, a display of any information with respect to quotations for or transactions in an NMS stock without also providing, in an equivalent manner, a consolidated display for such stock.

(2) The provisions of paragraph (c)(1) of this section shall not apply to a display of information on the trading floor or through the facilities of a national securities exchange or to a display in connection with the operation of a market linkage system implemented in accordance with an effective national market system plan.

(d) *Exemptions.* The Commission, by order, may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any person, security, or item of information, or any class or classes of persons, securities, or items of information, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

**§ 242.604 Display of customer limit orders.**

(a) *Specialists and OTC market makers.* For all NMS stocks:

(1) Each member of a national securities exchange that is registered by that exchange as a specialist, or is authorized by that exchange to perform functions substantially similar to that of

a specialist, shall publish immediately a bid or offer that reflects:

(i) The price and the full size of each customer limit order held by the specialist that is at a price that would improve the bid or offer of such specialist in such security; and

(ii) The full size of each customer limit order held by the specialist that:

(A) Is priced equal to the bid or offer of such specialist for such security;

(B) Is priced equal to the national best bid or national best offer; and

(C) Represents more than a *de minimis* change in relation to the size associated with the specialist's bid or offer.

(2) Each registered broker or dealer that acts as an OTC market maker shall publish immediately a bid or offer that reflects:

(i) The price and the full size of each customer limit order held by the OTC market maker that is at a price that would improve the bid or offer of such OTC market maker in such security; and

(ii) The full size of each customer limit order held by the OTC market maker that:

(A) Is priced equal to the bid or offer of such OTC market maker for such security;

(B) Is priced equal to the national best bid or national best offer; and

(C) Represents more than a *de minimis* change in relation to the size associated with the OTC market maker's bid or offer.

(b) *Exceptions.* The requirements in paragraph (a) of this section shall not apply to any customer limit order:

(1) That is executed upon receipt of the order.

(2) That is placed by a customer who expressly requests, either at the time that the order is placed or prior thereto pursuant to an individually negotiated agreement with respect to such customer's orders, that the order not be displayed.

(3) That is an odd-lot order.

(4) That is a block size order, unless a customer placing such order requests that the order be displayed.

(5) That is delivered immediately upon receipt to a national securities exchange or national securities association-sponsored system, or an electronic communications network that complies with the requirements of § 242.602(b)(5)(ii) with respect to that order.

(6) That is delivered immediately upon receipt to another exchange member or OTC market maker that complies with the requirements of this section with respect to that order.

(7) That is an "all or none" order.

(c) *Exemptions.* The Commission may exempt from the provisions of this

section, either unconditionally or on specified terms and conditions, any responsible broker or dealer, electronic communications network, national securities exchange, or national securities association if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system.

**§ 242.605 Disclosure of order execution information.**

**Preliminary Note:** Section 242.605 requires market centers to make available standardized, monthly reports of statistical information concerning their order executions. This information is presented in accordance with uniform standards that are based on broad assumptions about order execution and routing practices. The information will provide a starting point to promote visibility and competition on the part of market centers and broker-dealers, particularly on the factors of execution price and speed. The disclosures required by this section do not encompass all of the factors that may be important to investors in evaluating the order routing services of a broker-dealer. In addition, any particular market center's statistics will encompass varying types of orders routed by different broker-dealers on behalf of customers with a wide range of objectives. Accordingly, the statistical information required by this section alone does not create a reliable basis to address whether any particular broker-dealer failed to obtain the most favorable terms reasonably available under the circumstances for customer orders.

(a) *Monthly electronic reports by market centers.*

(1) Every market center shall make available for each calendar month, in accordance with the procedures established pursuant to paragraph (a)(2) of this section, a report on the covered orders in NMS stocks that it received for execution from any person. Such report shall be in electronic form; shall be categorized by security, order type, and order size; and shall include the following columns of information:

(i) For market orders, marketable limit orders, inside-the-quote limit orders, at-the-quote limit orders, and near-the-quote limit orders:

- (A) The number of covered orders;
- (B) The cumulative number of shares of covered orders;
- (C) The cumulative number of shares of covered orders cancelled prior to execution;

(D) The cumulative number of shares of covered orders executed at the receiving market center;

(E) The cumulative number of shares of covered orders executed at any other venue;

(F) The cumulative number of shares of covered orders executed from 0 to 9 seconds after the time of order receipt;

(G) The cumulative number of shares of covered orders executed from 10 to 29 seconds after the time of order receipt;

(H) The cumulative number of shares of covered orders executed from 30 seconds to 59 seconds after the time of order receipt;

(I) The cumulative number of shares of covered orders executed from 60 seconds to 299 seconds after the time of order receipt;

(J) The cumulative number of shares of covered orders executed from 5 minutes to 30 minutes after the time of order receipt; and

(K) The average realized spread for executions of covered orders; and

(ii) For market orders and marketable limit orders:

(A) The average effective spread for executions of covered orders;

(B) The cumulative number of shares of covered orders executed with price improvement;

(C) For shares executed with price improvement, the share-weighted average amount per share that prices were improved;

(D) For shares executed with price improvement, the share-weighted average period from the time of order receipt to the time of order execution;

(E) The cumulative number of shares of covered orders executed at the quote;

(F) For shares executed at the quote, the share-weighted average period from the time of order receipt to the time of order execution;

(G) The cumulative number of shares of covered orders executed outside the quote;

(H) For shares executed outside the quote, the share-weighted average amount per share that prices were outside the quote; and

(I) For shares executed outside the quote, the share-weighted average period from the time of order receipt to the time of order execution.

(2) Every national securities exchange on which NMS stocks are traded and each national securities association shall act jointly in establishing procedures for market centers to follow in making available to the public the reports required by paragraph (a)(1) of this section in a uniform, readily accessible, and usable electronic form. In the event there is no effective

national market system plan establishing such procedures, market centers shall prepare their reports in a consistent, usable, and machine-readable electronic format, and make such reports available for downloading from an Internet website that is free and readily accessible to the public.

(3) A market center shall make available the report required by paragraph (a)(1) of this section within one month after the end of the month addressed in the report.

(b) *Exemptions.* The Commission may, by order upon application, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this section, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

**§ 242.606 Disclosure of order routing information.**

(a) *Quarterly report on order routing.*

(1) Every broker or dealer shall make publicly available for each calendar quarter a report on its routing of non-directed orders in NMS securities during that quarter. For NMS stocks, such report shall be divided into three separate sections for securities that are listed on the New York Stock Exchange, Inc., securities that are qualified for inclusion in The Nasdaq Stock Market, Inc., and securities that are listed on the American Stock Exchange LLC or any other national securities exchange. Such report also shall include a separate section for NMS securities that are option contracts. Each of the four sections in a report shall include the following information:

(i) The percentage of total customer orders for the section that were non-directed orders, and the percentages of total non-directed orders for the section that were market orders, limit orders, and other orders;

(ii) The identity of the ten venues to which the largest number of total non-directed orders for the section were routed for execution and of any venue to which five percent or more of non-directed orders were routed for execution, the percentage of total non-directed orders for the section routed to the venue, and the percentages of total non-directed market orders, total non-directed limit orders, and total non-directed other orders for the section that were routed to the venue; and

(iii) A discussion of the material aspects of the broker's or dealer's relationship with each venue identified

pursuant to paragraph (a)(1)(ii) of this section, including a description of any arrangement for payment for order flow and any profit-sharing relationship.

(2) A broker or dealer shall make the report required by paragraph (a)(1) of this section publicly available within one month after the end of the quarter addressed in the report.

(b) *Customer requests for information on order routing.*

(1) Every broker or dealer shall, on request of a customer, disclose to its customer the identity of the venue to which the customer's orders were routed for execution in the six months prior to the request, whether the orders were directed orders or non-directed orders, and the time of the transactions, if any, that resulted from such orders.

(2) A broker or dealer shall notify customers in writing at least annually of the availability on request of the information specified in paragraph (b)(1) of this section.

(c) *Exemptions.* The Commission may, by order upon application, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this section, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

#### **§ 242.607 Customer account statements.**

(a) No broker or dealer acting as agent for a customer may effect any transaction in, induce or attempt to induce the purchase or sale of, or direct orders for purchase or sale of, any NMS stock or a security authorized for quotation on an automated inter-dealer quotation system that has the characteristics set forth in section 17B of the Act (15 U.S.C. 78q-2), unless such broker or dealer informs such customer, in writing, upon opening a new account and on an annual basis thereafter, of the following:

(1) The broker's or dealer's policies regarding receipt of payment for order flow from any broker or dealer, national securities exchange, national securities association, or exchange member to which it routes customers' orders for execution, including a statement as to whether any payment for order flow is received for routing customer orders and a detailed description of the nature of the compensation received; and

(2) The broker's or dealer's policies for determining where to route customer orders that are the subject of payment for order flow absent specific instructions from customers, including a

description of the extent to which orders can be executed at prices superior to the national best bid and national best offer.

(b) *Exemptions.* The Commission, upon request or upon its own motion, may exempt by rule or by order, any broker or dealer or any class of brokers or dealers, security or class of securities from the requirements of paragraph (a) of this section with respect to any transaction or class of transactions, either unconditionally or on specified terms and conditions, if the Commission determines that such exemption is consistent with the public interest and the protection of investors.

#### **§ 242.608 Filing and amendment of national market system plans.**

(a) *Filing of national market system plans and amendments thereto.*

(1) Any two or more self-regulatory organizations, acting jointly, may file a national market system plan or may propose an amendment to an effective national market system plan ("proposed amendment") by submitting the text of the plan or amendment to the Secretary of the Commission, together with a statement of the purpose of such plan or amendment and, to the extent applicable, the documents and information required by paragraphs (a)(4) and (5) of this section.

(2) The Commission may propose amendments to any effective national market system plan by publishing the text thereof, together with a statement of the purpose of such amendment, in accordance with the provisions of paragraph (b) of this section.

(3) Self-regulatory organizations are authorized to act jointly in:

(i) Planning, developing, and operating any national market subsystem or facility contemplated by a national market system plan;

(ii) Preparing and filing a national market system plan or any amendment thereto; or

(iii) Implementing or administering an effective national market system plan.

(4) Every national market system plan filed pursuant to this section, or any amendment thereto, shall be accompanied by:

(i) Copies of all governing or constituent documents relating to any person (other than a self-regulatory organization) authorized to implement or administer such plan on behalf of its sponsors; and

(ii) To the extent applicable:

(A) A detailed description of the manner in which the plan or amendment, and any facility or procedure contemplated by the plan or amendment, will be implemented;

(B) A listing of all significant phases of development and implementation (including any pilot phase) contemplated by the plan or amendment, together with the projected date of completion of each phase;

(C) An analysis of the impact on competition of implementation of the plan or amendment or of any facility contemplated by the plan or amendment;

(D) A description of any written understandings or agreements between or among plan sponsors or participants relating to interpretations of the plan or conditions for becoming a sponsor or participant in the plan; and

(E) In the case of a proposed amendment, a statement that such amendment has been approved by the sponsors in accordance with the terms of the plan.

(5) Every national market system plan, or any amendment thereto, filed pursuant to this section shall include a description of the manner in which any facility contemplated by the plan or amendment will be operated. Such description shall include, to the extent applicable:

(i) The terms and conditions under which brokers, dealers, and/or self-regulatory organizations will be granted or denied access (including specific procedures and standards governing the granting or denial of access);

(ii) The method by which any fees or charges collected on behalf of all of the sponsors and/or participants in connection with access to, or use of, any facility contemplated by the plan or amendment will be determined and imposed (including any provision for distribution of any net proceeds from such fees or charges to the sponsors and/or participants) and the amount of such fees or charges;

(iii) The method by which, and the frequency with which, the performance of any person acting as plan processor with respect to the implementation and/or operation of the plan will be evaluated; and

(iv) The method by which disputes arising in connection with the operation of the plan will be resolved.

(6) In connection with the selection of any person to act as plan processor with respect to any facility contemplated by a national market system plan (including renewal of any contract for any person to so act), the sponsors shall file with the Commission a statement identifying the person selected, describing the material terms under which such person is to serve as plan processor, and indicating the solicitation efforts, if any, for alternative plan processors, the alternatives

considered and the reasons for selection of such person.

(7) Any national market system plan (or any amendment thereto) which is intended by the sponsors to satisfy a plan filing requirement contained in any other section of this Regulation NMS and part 240, subpart A of this chapter shall, in addition to compliance with this section, also comply with the requirements of such other section.

(b) *Effectiveness of national market system plans.*

(1) The Commission shall publish notice of the filing of any national market system plan, or any proposed amendment to any effective national market system plan (including any amendment initiated by the Commission), together with the terms of substance of the filing or a description of the subjects and issues involved, and shall provide interested persons an opportunity to submit written comments. No national market system plan, or any amendment thereto, shall become effective unless approved by the Commission or otherwise permitted in accordance with paragraph (b)(3) of this section.

(2) Within 120 days of the date of publication of notice of filing of a national market system plan or an amendment to an effective national market system plan, or within such longer period as the Commission may designate up to 180 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or as to which the sponsors consent, the Commission shall approve such plan or amendment, with such changes or subject to such conditions as the Commission may deem necessary or appropriate, if it finds that such plan or amendment is necessary or appropriate in the public interest, for the protection of investors and the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanisms of, a national market system, or otherwise in furtherance of the purposes of the Act. Approval of a national market system plan, or an amendment to an effective national market system plan (other than an amendment initiated by the Commission), shall be by order. Promulgation of an amendment to an effective national market system plan initiated by the Commission shall be by rule.

(3) A proposed amendment may be put into effect upon filing with the Commission if designated by the sponsors as:

(i) Establishing or changing a fee or other charge collected on behalf of all of the sponsors and/or participants in

connection with access to, or use of, any facility contemplated by the plan or amendment (including changes in any provision with respect to distribution of any net proceeds from such fees or other charges to the sponsors and/or participants);

(ii) Concerned solely with the administration of the plan, or involving the governing or constituent documents relating to any person (other than a self-regulatory organization) authorized to implement or administer such plan on behalf of its sponsors; or

(iii) Involving solely technical or ministerial matters. At any time within 60 days of the filing of any such amendment, the Commission may summarily abrogate the amendment and require that such amendment be refiled in accordance with paragraph (a)(1) of this section and reviewed in accordance with paragraph (b)(2) of this section, if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanisms of, a national market system or otherwise in furtherance of the purposes of the Act.

(4) Notwithstanding the provisions of paragraph (b)(1) of this section, a proposed amendment may be put into effect summarily upon publication of notice of such amendment, on a temporary basis not to exceed 120 days, if the Commission finds that such action is necessary or appropriate in the public interest, for the protection of investors or the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanisms of, a national market system or otherwise in furtherance of the purposes of the Act.

(5) Any plan (or amendment thereto) in connection with:

(i) The planning, development, operation, or regulation of a national market system (or a subsystem thereof) or one or more facilities thereof; or

(ii) The development and implementation of procedures and/or facilities designed to achieve compliance by self-regulatory organizations and/or their members of any section of this Regulation NMS and part 240, subpart A of this chapter promulgated pursuant to section 11A of the Act (15 U.S.C. 78k-1), approved by the Commission pursuant to section 11A of the Act (or pursuant to any rule or regulation thereunder) prior to the effective date of this section (either temporarily or permanently) shall be deemed to have been filed and approved pursuant to this section and no additional filing need be made by the sponsors with respect to such plan or

amendment; *provided, however*, that all terms and conditions associated with any such approval (including time limitations) shall continue to be applicable; *provided, further*, that any amendment to such plan filed with or approved by the Commission on or after the effective date of this section shall be subject to the provisions of, and considered in accordance with the procedures specified in, this section.

(c) *Compliance with terms of national market system plans.* Each self-regulatory organization shall comply with the terms of any effective national market system plan of which it is a sponsor or a participant. Each self-regulatory organization also shall, absent reasonable justification or excuse, enforce compliance with any such plan by its members and persons associated with its members.

(d) *Appeals.* The Commission may, in its discretion, entertain appeals in connection with the implementation or operation of any effective national market system plan as follows:

(1) Any action taken or failure to act by any person in connection with an effective national market system plan (other than a prohibition or limitation of access reviewable by the Commission pursuant to section 11A(b)(5) or section 19(d) of the Act (15 U.S.C. 78k-1(b)(5) or 78s(d))) shall be subject to review by the Commission, on its own motion or upon application by any person aggrieved thereby (including, but not limited to, self-regulatory organizations, brokers, dealers, issuers, and vendors), filed not later than 30 days after notice of such action or failure to act or within such longer period as the Commission may determine.

(2) Application to the Commission for review, or the institution of review by the Commission on its own motion, shall not operate as a stay of any such action unless the Commission determines otherwise, after notice and opportunity for hearing on the question of a stay (which hearing may consist only of affidavits or oral arguments).

(3) In any proceedings for review, if the Commission, after appropriate notice and opportunity for hearing (which hearing may consist solely of consideration of the record of any proceedings conducted in connection with such action or failure to act and an opportunity for the presentation of reasons supporting or opposing such action or failure to act) and upon consideration of such other data, views, and arguments as it deems relevant, finds that the action or failure to act is in accordance with the applicable provisions of such plan and that the applicable provisions are, and were,

applied in a manner consistent with the public interest, the protection of investors, the maintenance of fair and orderly markets, and the removal of impediments to, and the perfection of the mechanisms of a national market system, the Commission, by order, shall dismiss the proceeding. If the Commission does not make any such finding, or if it finds that such action or failure to act imposes any burden on competition not necessary or appropriate in furtherance of the purposes of the Act, the Commission, by order, shall set aside such action and/or require such action with respect to the matter reviewed as the Commission deems necessary or appropriate in the public interest, for the protection of investors, and the maintenance of fair and orderly markets, or to remove impediments to, and perfect the mechanisms of, a national market system.

(e) *Exemptions.* The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any self-regulatory organization, member thereof, or specified security, if the Commission determines that such exemption is consistent with the public interest, the protection of investors, the maintenance of fair and orderly markets and the removal of impediments to, and perfection of the mechanisms of, a national market system.

**§ 242.609 Registration of securities information processors: form of application and amendments.**

(a) An application for the registration of a securities information processor shall be filed on Form SIP (§ 249.1001) in accordance with the instructions contained therein.

(b) If any information reported in items 1–13 or item 21 of Form SIP or in any amendment thereto is or becomes inaccurate for any reason, whether before or after the registration has been granted, the securities information processor shall promptly file an amendment on Form SIP correcting such information.

(c) The Commission, upon its own motion or upon application by any securities information processor, may conditionally or unconditionally exempt any securities information processor from any provision of the rules or regulations adopted under section 11A(b) of the Act (15 U.S.C. 78k–1(b)).

(d) Every amendment filed pursuant to this section shall constitute a “report” within the meaning of sections 17(a), 18(a) and 32(a) of the Act (15 U.S.C. 78q(a), 78r(a), and 78ff(a)).

**§ 242.610 Access to quotations.**

(a) *Quotations of SRO trading facility.* A national securities exchange or national securities association shall not impose unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member of the national securities exchange or national securities association to the quotations in an NMS stock displayed through its SRO trading facility.

(b) *Quotations of SRO display-only facility.*

(1) Any trading center that displays quotations in an NMS stock through an SRO display-only facility shall provide a level and cost of access to such quotations that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities in that stock.

(2) Any trading center that displays quotations in an NMS stock through an SRO display-only facility shall not impose unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access to such quotations through a member, subscriber, or customer of the trading center.

(c) *Fees for access to protected quotations.* A trading center shall not impose, nor permit to be imposed, any fee or fees for the execution of orders against its protected quotations in an NMS stock that exceed or accumulate to more than the following limits:

(1) If the price of a protected quotation is \$1.00 or more, the fee or fees cannot exceed or accumulate to more than \$0.003 per share; or

(2) If the price of a protected quotation is less than \$1.00, the fee or fees cannot exceed or accumulate to more than 0.3% of the quotation price per share.

(d) *Locking or crossing quotations.*

Each national securities exchange and national securities association shall establish and enforce rules that:

(1) Require its members reasonably to avoid displaying quotations that lock or cross any protected quotation in an NMS stock, and to avoid displaying manual quotations that lock or cross any quotation in an NMS stock disseminated pursuant to an effective national market system plan;

(2) Are reasonably designed to assure the reconciliation of locked or crossed quotations in an NMS stock; and

(3) Prohibit its members from engaging in a pattern or practice of displaying quotations that lock or cross any protected quotation in an NMS stock, or of displaying manual quotations that lock or cross any quotation in an NMS stock disseminated

pursuant to an effective national market system plan.

(e) *Exemptions.* The Commission, by order, may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any person, security, quotations, orders, or fees, or any class or classes of persons, securities, quotations, orders, or fees, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

**§ 242.611 Order protection rule.**

(a) *Reasonable policies and procedures.*

(1) A trading center shall establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs of protected quotations in NMS stocks that do not fall within an exception set forth in paragraph (b) of this section and, if relying on such an exception, that are reasonably designed to assure compliance with the terms of the exception.

(2) A trading center shall regularly surveil to ascertain the effectiveness of the policies and procedures required by paragraph (a)(1) of this section and shall take prompt action to remedy deficiencies in such policies and procedures.

(b) *Exceptions.*

(1) The transaction that constituted the trade-through was effected when the trading center displaying the protected quotation that was traded through was experiencing a failure, material delay, or malfunction of its systems or equipment when the trade-through occurred.

(2) The transaction that constituted the trade-through was not a “regular way” contract.

(3) The transaction that constituted the trade-through was a single-priced opening, reopening, or closing transaction by the trading center.

(4) The transaction that constituted the trade-through was executed at a time when a protected bid was priced higher than a protected offer in the NMS stock.

(5) The transaction that constituted the trade-through was the execution of an order identified as an intermarket sweep order.

(6) The transaction that constituted the trade-through was effected by a trading center that simultaneously routed an intermarket sweep order to execute against the full displayed size of any protected quotation in the NMS stock that was traded through.

(7) The transaction that constituted the trade-through was the execution of an order at a price that was not based, directly or indirectly, on the quoted

price of the NMS stock at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made.

(8) The trading center displaying the protected quotation that was traded through had displayed, within one second prior to execution of the transaction that constituted the trade-through, a best bid or best offer, as applicable, for the NMS stock with a price that was equal or inferior to the price of the trade-through transaction.

(c) *Intermarket sweep orders.* The trading center, broker, or dealer responsible for the routing of an intermarket sweep order shall take reasonable steps to establish that such order meets the requirements set forth in § 242.600(b)(30).

(d) *Exemptions.* The Commission, by order, may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any person, security, transaction, quotation, or order, or any class or classes of persons, securities, quotations, or orders, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

**§ 242.612 Minimum pricing increment.**

(a) No national securities exchange, national securities association, alternative trading system, vendor, or broker or dealer shall display, rank, or accept from any person a bid or offer, an order, or an indication of interest in any NMS stock equal to or greater than \$1.00 in an increment smaller than \$0.01.

(b) No national securities exchange, national securities association, alternative trading system, vendor, or broker or dealer shall display, rank, or accept from any person a bid or offer, an order, or an indication of interest in any NMS stock less than \$1.00 in an increment smaller than \$0.0001.

(c) *Exemptions.* The Commission, by order, may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any person, security, quotation, or order, or any class or classes of persons, securities, quotations, or orders, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

**PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934**

32. The authority citation for part 249 continues to read in part as follows:

**Authority:** 15 U.S.C. 78a *et seq.* and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*

33. Section 249.1001 is revised to read as follows:

**§ 249.1001 Form SIP, for application for registration as a securities information processor or to amend such an application or registration.**

This form shall be used for application for registration as a securities information processor, pursuant to section 11A(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78k-1(b)) and § 242.609 of this chapter, or to amend such an application or registration.

34. Form SIP (referenced in § 249.1001) is amended by revising Instruction 6 of General Instructions for Preparing and Filing Form SIP to read as follows:

**Note:** The text of Form SIP does not and this amendment will not appear in the Code of Federal Regulations.

**FORM SIP**

\* \* \* \* \*

**GENERAL INSTRUCTIONS FOR PREPARING AND FILING FORM SIP**

\* \* \* \* \*

6. Rule 609(b) of Regulation NMS requires that if any information contained in items 1 through 13 or item 21 of this application, or any supplement or amendment thereto, is or becomes inaccurate for any reason, an amendment must be filed promptly on Form SIP correcting such information.

\* \* \* \* \*

**PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940**

35. The authority citation for part 270 continues to read in part as follows:

**Authority:** 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

\* \* \* \* \*

36. Section 270.17a-7 is amended by revising paragraph (b)(1) to read as follows:

**§ 270.17a-7 Exemption of certain purchase or sale transactions between an investment company and certain affiliated persons thereof.**

\* \* \* \* \*

(b) \* \* \*

(1) If the security is an “NMS stock” as that term is defined in 17 CFR 242.600, the last sale price with respect to such security reported in the consolidated transaction reporting system (“consolidated system”) or the average of the highest current independent bid and lowest current independent offer for such security (reported pursuant to 17 CFR 242.602) if there are no reported transactions in the consolidated system that day; or

\* \* \* \* \*

By the Commission.

Dated: December 16, 2004.

**J. Lynn Taylor,**

*Assistant Secretary.*

[FR Doc. 04-27934 Filed 12-26-04; 8:45 am]

**BILLING CODE 8010-01-P**