



MEMORANDUM

From: Richard G. Ketchum, President, The Nasdaq Stock Market

To: Mr. Joel Seligman, Dean and Ethan A. H. Shipley University Professor,
Washington University School of Law

Date: June 14, 2001

Re: SEC Review of Market Data Fees

As you requested at the May 14, 2001, meeting of the SEC Advisory Committee on Market Information (“Advisory Committee”), Nasdaq has analyzed the extent to which market data fees should be filed with and reviewed by the Securities and Exchange Commission (“SEC”). Nasdaq’s analysis assumes a national market system (“NMS”) composed of competing consolidators that are each subject to the Vendor Display Rule, the arrangement supported by a plurality of Advisory Committee members at the May 14 meeting. In addition, our analysis assumes that the Vendor Display Rule will continue to require vendors to disseminate only the consolidated best bid, best offer (“NBBO”) and last sale information for a particular security, based on each market’s respective best bid, best offer (“BBO”) and last sale data (“mandatory minimum”). The proposed structure also will permit the sale and dissemination of additional data (“enhanced data”) that markets and other market participants, including broker-dealers and alternative trading systems, may wish to provide to their customers, the end users of that data.

Determining the scope of SEC review of market data products and fees requires that we strike a delicate balance. Investor protection is, of course, the paramount concern. Nasdaq believes that SEC oversight of self-regulatory organization (“SRO”) proposed rule changes has served investors well and should continue to apply in certain limited circumstances. Investors also benefit, however, from the availability of the widest potential range of data upon which to base their investment decisions. Therefore, market data policy should create incentives for markets to innovate and to offer new, enhanced-data products with expanded pre- and post-trade data, including historical information.

We believe that competitive forces, if permitted to operate more freely, will create incentives for markets to offer a wide range of enhanced market data for fair prices. To compete effectively, each exchange must have discretion to determine how to make enhanced information available to the appropriate constituency. This discretion would include (but would not be limited to) entering into contracts between exchanges and market data vendors regulating the terms of receipt of enhanced information and establishing and collecting charges directly from such vendors, on behalf of their end-user customers.

In light of the goals of protecting investors and encouraging competition, Nasdaq submits a three-tiered approach to SEC review of market data fees.

- **First**, each individual SRO-operated market and exclusive processor would be subject to a full notice and comment rule-making process with respect to market data fees for mandatory minimum information. Under this approach, the SEC would make a finding that market data fees proposed for such mandatory information were fair and reasonable, and not unreasonably discriminatory, in accordance with the Exchange Act.
- **Second**, market data fees for enhanced data would also be filed with the SEC, and would be effective immediately upon filing. The SEC could abrogate such fees if it finds that the Exchange Act warrants such action.
- **Third**, commercial products and services, including market data products, that are outside the core functions of an SRO-operated market should not be subject to any rule-filing requirements. Such products are not essential to investors and should be subject only to the natural forces of supply and demand and competition.

Mandatory Minimum Information

The need to protect investors against improper pricing of market data is highest with respect to the NBBO because it is among the most vital pieces of market information to market participants.¹ The SEC has recognized, as an integral part of the formation of a NMS, the importance of providing investors with the NBBO “so that buyers and sellers of securities, wherever located, can make informed decisions and not pay more than the lowest price at which someone is willing to sell nor sell for less than the highest price at which a buyer is prepared to offer.”² A reliable and widely disseminated NBBO ensures that customers know the best prices and sizes available in the constituent exchanges. In addition, the NBBO assists broker-dealers in complying with applicable rules and regulations, including compliance with their short sale and best execution obligations. The NBBO continues to be important in a decimal trading environment, as a reflection of the best price at which market participants are willing to trade at a single point in time.

As a result, Nasdaq believes that it continues to be in the best interests of investors that the SEC requires full notice and comment on proposals that would impact the pricing or distribution of mandatory minimum data. As discussed below, however, SEC review of other market data products and related fees should be limited or eliminated, leaving the development of such products to competitive forces.

¹ See *Market Information: Searching for Consensus*, SEC Commissioner Paul R. Carey, Twenty-Eighth Annual Securities Regulation Institute, January 25, 2001. In his speech highlighting the issues being considered by the Advisory Committee, Commissioner Carey noted that even in a decimal trading environment, “the inability to discover the best prices in the national market would be a major step backward.”

² Securities and Exchange Commission, *Statement on the Future Structure of the Securities Markets* (Feb. 2, 1972), 37 FR 5286.

Enhanced Data

Under a competing consolidator model, exchanges and individual market participants may choose to provide enhanced data (*i.e.*, data other than real-time BBO and last sale data), to consolidators and other vendors directly. Exchanges will be competing against each other and against non-SRO markets for the sale of their enhanced data. They should be able to compete on a fair and level playing field, without being unduly encumbered by regulatory oversight and scrutiny by competitors through the public comment process. In a truly competitive environment, free market principles will result in prices that are “fair and reasonable,” and still based on the value that the information provides to the industry.

Still, as trading in decimals expands, there is no disputing that market quotation information below a particular market’s BBO becomes increasingly important to exchanges, broker-dealers, and investors alike. The need for investor protection, therefore, remains a factor in determining the appropriate level of SEC oversight.

To strike an appropriate balance between the important, though not essential, nature of enhanced data and the benefit of the richest possible competition, Nasdaq proposes that fees for enhanced data products be effective upon filing. The SEC could abrogate a fee for such enhanced data products only if it found that the Exchange Act required such action.

Commercial Products Outside Core SRO Functions

Nasdaq believes that the requirements of Section 19(b) of the Exchange Act serve vital regulatory functions, particularly with respect to the fundamentally important or core services of an SRO. We do not believe, however, that the regulatory protections offered by Commission review and approval of proposed rule changes are necessary for services or products that are supplemental to, and independent of, the primary functions of an SRO. Unlike most SRO rules, which are mandatory for all members, there are services and products offered by Nasdaq that are optional for members. For these services and products, the procedural requirements of Section 19(b) significantly hamper the ability of an SRO-operated market to compete effectively with other marketplaces that are not subject to the same regulatory requirements.

In addition, product-specific rules do not benefit from notice and comment. Unlike rules regarding member regulation, firm oversight, and cross-market issues, these products and services are not mandatory and are not central to the core functionality of a marketplace. Such products and services are better left to the marketplace to design and implement in the exercise of business judgment and in the interests of preserving their competitive position vis a vis other marketplaces. Subjecting such rules to notice and comment procedures could eliminate any competitive advantage that they were designed to capture.

The Commission itself has acknowledged that removing non-essential or optional services offered by an SRO from the Section 19(b) rule filing process is consistent with the Exchange Act. The Commission, in connection with Nasdaq’s acquisition and operation of a software

development company, Financial Systemware, Inc. (“FSI”),³ granted Nasdaq an exemption from Section 19(b) that permits FSI to modify its products, offer new products, and set fees for its products without going through the rule-change procedures. The Commission drew a policy distinction between essential or core SRO services and ancillary, non-essential or optional services such as those offered by FSI. It determined that the latter category of services can be offered on a competitive basis without notice and comment rule-making, yet in a manner consistent with the goals and requirements of the Exchange Act.⁴ The Commission sought to promote efficiency and competition in the market for software services for broker-dealers, while also upholding the regulatory objectives of the Exchange Act.⁵

Nasdaq strongly encourages the Advisory Committee to explore further the distinction between core SRO services and ancillary, non-essential or optional services, and to recommend that the Commission use its broad exemptive authority to exempt this class of services from the filing requirements of Section 19(b) of the Exchange Act.

Conclusion

As we move into a new phase of the evolution of our market structure, we must ensure that the core policy goals established by Congress in 1975 – including broad public access to consolidated market data, the maintenance of stable and orderly markets, and the ability to promote competition – are preserved and encouraged to the greatest extent possible. Nasdaq believes that its proposed structure for SEC oversight of market data products and fees will encourage competition and innovation among markets, resulting in the development of quality market data. Moreover, this proposal will ensure that investors have broad access to such valuable market data, at prices that are fair and reasonable.

³ Securities Exchange Act Release No. 42713 (April 24, 2000), 65 FR 25401.

⁴ *Id.* at 25403. The Commission recently approved a permanent exemption. *See* Securities Exchange Act Release No. 44201 (April 18, 2001), 66 FR 21025.

⁵ 65 FR at 25404.