

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :
: :
: INITIAL DECISION
THE NASDAQ STOCK MARKET, LLC : October 1, 2008
: :
: :

APPEARANCES: Jeffrey S. Davis for The Nasdaq Stock Market

Steven J. Abrams and Dean Yuzek of Ingram, Yuzek, Gainen, Carroll &
Bertolotti, LLP, for the Consolidated Tape Association

BEFORE: Robert G. Mahony, Administrative Law Judge

INTRODUCTION

Background

Formation of the Consolidated Tape Association

In 1972, the Securities and Exchange Commission (Commission) adopted a rule that required every national exchange and the National Association of Securities Dealers (NASD) to file with the Commission a plan providing for the collection, processing, and dissemination of last sale price information. See Reporting of Market Information on Transactions in Listed Securities, Exchange Act Release No. 9850 (Nov. 8, 1972). In 1974, the Commission approved a joint industry Consolidated Tape Plan (Plan) that was filed with the Commission on behalf of several national exchanges. See Notice of Commission Action Declaring Effective a Consolidated Tape Plan Filed Pursuant to Rule 17a-15 Under the Securities Exchange Act of 1934, 4 SEC Docket 271 (May 10, 1974). The Plan called for the establishment of an association, the Consolidated Tape Association (CTA), to administer the Plan and oversee the Securities Industry Automation Corporation (SIAC) as the initial data processor of the Plan. See Collection and Dissemination of Transaction Reports 15 SEC Docket 1355, 1356 (Oct. 20, 1978). The CTA currently consists of eleven Plan Participants (Participants), all of whom are

competitors.¹ Each Participant in the Plan reports last sale prices to the SIAC. The SIAC then disseminates the information to third parties for a fee. The purchasers of the information further distribute the quotes to broker-dealers and other members of the public. The Participants share revenues based upon the volume of transactions they report.

In 2002, The Nasdaq Stock Market, LLC (Nasdaq), expressed interest in joining the CTA and asked the Participants to calculate an entry fee.² (Tr. 36.) On March 23, 2006, the CTA Operating Committee (Operating Committee) voted to impose on Nasdaq a new entrant fee of \$833,682 to join the CTA.³ On June 30, 2006, Nasdaq petitioned the Commission for a review of action taken by the Operating Committee pursuant to Securities Exchange Act of 1934 (Exchange Act) Section 11A(b)(5) and Exchange Act Rule 608(d).⁴ Nasdaq alleged that the new entrant fee was excessive and constituted an unlawful denial of access to the CTA's systems.

The Commission issued its Order Accepting Jurisdiction (Order) over Nasdaq's petition on June 14, 2007. See 90 SEC Docket 2553 (June 14, 2007). The Order determined that the records assembled by the CTA for review by the Commission lacked sufficient information in order to make necessary determinations about the entry fee. Accordingly, the parties were directed to answer a series of questions set forth in the Order.⁵ Further, the Commission directed that an Administrative Law Judge be designated to preside over the case.

¹ The current members are the American Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, Financial Industry Regulatory Authority, International Securities Exchange, Nasdaq, National Stock Exchange, New York Stock Exchange, NYSE Arca, and the Philadelphia Stock Exchange.

² Citations to the transcript of the hearing will be noted as "(Tr. __.)." Citations to the joint exhibits will be noted as "(Ex. __.)." Citations to Nasdaq's and CTA's post-hearing briefs will be noted as "(Nasdaq Post-Hearing Br. at __.)," and "(CTA Post-Hearing Br. at __.)," respectively. Citations to Nasdaq's reply brief will be noted as "(Nasdaq Reply Br. at __.)." Citations to Nasdaq's Brief in Support of Application for Review will be noted as "(Nasdaq App. Br. at __.)."

³ The CTA notes that preparation of the new entrant fee required analysis of books and records that were not originally prepared in anticipation of calculating the new entrant fee. As a result, the calculation of the new entry fee required significant judgment in the identification and allocation of costs that were appropriately recoverable in accordance with the entry fee amendment. (Tr. 19-20, 430-31.)

⁴ Exchange Act Section 11A(b)(5)(A) and Rule 608 provide that, upon application by an aggrieved person, any prohibition or limitation of access to services by a registered securities information processor shall be subject to Commission review. The CTA is registered as an exclusive securities information processor. See Applications for Registration as Securities Information Processors, 8 SEC Docket 1099 (Jan. 22, 1976) (granting registration to the CTA).

⁵ The questions posed by the Commission primarily address the CTA's accounting policies and how it maintains its books and records.

A hearing was held on November 8 and 9, 2007, at which Nasdaq called one witness and the CTA called three. Thirty-one documents were introduced into evidence. The CTA also provided its answers to the questions included in the Order.⁶ Nasdaq did not provide answers other than to disagree with the CTA's answer to question 10. (Tr. 8.) At the conclusion of the hearing, briefs were filed by the parties as well as the Division of Trading and Markets (Division) as amicus curiae. Upon completion of the briefing, the record was transmitted to the Office of the Secretary. On April 30, 2008, the Commission issued its Order Remanding Case to Administrative Law Judge for Issuance of Initial Decision Pursuant to Commission's Rule of Practice. See Exchange Act Release No. 57741 (Apr. 30, 2008.)

Nasdaq alleges that the CTA did not follow the newly adopted Plan amendment for computing the new participant entry fee because it included several items that Nasdaq considered improper for inclusion. (Tr. 6.) These items are historical operating costs, an adjustment for inflation, and averaging the entry fee for the tenth and eleventh participant. (Tr. 21-22.) Nasdaq also alleges that the entry fee calculation is improper because it relies upon a hypothetical calculation (Example) that was not approved by the Operating Committee. (Nasdaq Post-Hearing Br. at 14-18.) Further, the Example was not reviewed or endorsed by the Division nor included in the Commission's release adopting the amendment to the Plan. (Nasdaq Post-Hearing Br. at 14-18.) Finally, Nasdaq alleges that the fee, as computed, is unfair and imposes a burden on competition. (Tr. 22.) In its Post-Hearing Brief, Nasdaq requested an exemption from the requirement to pay any entry fee. (Nasdaq Post-Hearing Br. at 18-21.)

CTA's position is that "the \$833,682 fee strictly complied with the Plans' Entry-fee Criteria and the Example and represented a fair, reasonable and appropriate fee to charge for Nasdaq's entry into the Plans." (CTA Post-Hearing Br. at 1.)

FINDINGS OF FACT

The findings and conclusions herein are based on the entire record. I applied preponderance of the evidence as the standard of proof. See Steadman v. SEC, 450 U.S. 91, 97-104 (1981). I have considered and rejected all arguments, proposed findings, and conclusions that are inconsistent with this Initial Decision. All motions not previously granted are denied.

The Fee for Nasdaq to Enter the CTA

After Nasdaq requested that a new entry fee be calculated, the Participants retained Deloitte & Touche (Deloitte) to determine the fee. (Tr. 34-35, 37.) In October 2002, Deloitte concluded that the fee should be \$3.3 million, attributable primarily to historical costs of the

⁶ In response to one question, the CTA indicated that it does not maintain its books and records in accordance with generally accepted accounting principles (GAAP). (Tr. 210.) Accordingly, the CTA was unable to provide answers for several questions. Notwithstanding the fact that it does not prepare GAAP based financial statements, the CTA stated that, for the purposes of preparing the entry fee, it did not include expenditures that were not able to be capitalized under GAAP.

system. (Tr. 38.) Thereafter, in March 2003, the Division expressed concern to the Participants regarding the methodology used to calculate the fee and the competitive burdens it may impose. See Order Approving Seventh Substantive Amendment to the Second Restatement of the Consolidated Tape Association, 84 SEC Docket 4136, 4137 n.10 (Mar. 17, 2005) (Adopting Release). In August and November 2004, the Division sent the CTA letters asking it to amend the Plan with respect to the new entry fee. Id. at 4137 n.12. In its correspondence with the CTA, the Division emphasized that the new entrant fee “should be based solely upon objective criteria and costs that can easily be calculated”. Id. at 4137.

On November 29, 2004, Thomas Haley (Haley), Chairman of the Operating Committee, e-mailed the Division and Plan Participants and requested a telephone conference call that afternoon. (Ex. 17 at 2.) The Division replied that its letters regarding the new entrant fee were clear and that it believed a meeting was unnecessary. (Ex. 17 at 2.) The Division further advised that the deadline for the amendment was December 3, 2004. (Ex. 17 at 2.) In response to the Division, Haley replied in an e-mail sent at 12:31 p.m. that “the [proposed amendment] language is still surrounded with significant uncertainty as to how it is to work in actual practice.” (Ex. 17 at 1.) Haley further stated that an Example would supplement the proposed language and illustrate how the amendment language would be applied in calculating a new entrant fee. (Ex. 17 at 1.)

Brian Faughnan (Faughnan), the Managing Director of SIAC, had advised Haley of the difficulty of calculating the entry fee based upon the language of the amendment. (Tr. 329.) SIAC could not determine what could or could not be included in the new entrant fee and SIAC needed additional guidance which was provided by the Example. (Tr. 329-33.) In preparing the new entrant fee calculation, Haley instructed Faughnan that SIAC was to follow the language of the amendment and the Example. (Tr. 334-35.)

Haley sent another e-mail to the Division and Plan Participants on November 29, 2004, at 5:39 p.m. (Ex. 18.) This e-mail stated that the proposed amendment for the new entrant fee was not complete at that time; however, a draft of the Example was attached to the e-mail. (Tr. 47-48; Ex. 18.) The recipients of these e-mails included Eugene Lopez (Lopez), a former Senior Vice President of Nasdaq, who was its representative to the CTA from 2000 to 2005. (Tr. 30-31.) Lopez did not receive a copy of the Example before November 29, 2004, and he does not recall that the Example was discussed at an Operating Committee meeting. (Tr. 46.) However, Lopez agreed with Haley that uncertainty surrounded the Plan amendment as to how it would work in actual practice. (Tr. 73-74.) He also agreed that there was a need for an illustration of the calculation, which was being developed, so that the Participants understood it. (Tr. 74-75.) Lopez left Nasdaq in late 2005, several months before the Operating Committee approved the new entrant fee. (Tr. 30-31.)

Plan Entry Fee Criteria Changed

A proposed Plan amendment was sent by Haley to the Commission by cover letter, dated December 3, 2004, describing, inter alia, “Procedures for New Entrants to Join Plans.” (Ex. 1A; Ex. 19.) The amendment allows the Participants to consider one or both of the following in determining a new entrant’s fee: (1) the portion of costs previously paid by the CTA for the

development, expansion, and maintenance of the CTA's facilities which, under GAAP, could have been treated as capital expenditures and, if so treated, would have been amortized over the five years preceding the admission of the new Participant (and for this purpose all such capital expenditures shall be deemed to have a five year amortizable life); and (2) previous amounts paid by other Participants when they joined the Plans. See 84 SEC Docket at 4137. In addition, the amendment requires the new Participant to reimburse the SIAC for the costs that it incurs in modifying the Consolidated Tape (CTS) and Consolidated Quote (CQS) systems to accommodate the new Participant and for any additional capacity costs. Id. The new entrant fee allows Nasdaq to join the Consolidated Quotation Plan in addition to the CTA Plan. See 90 SEC Docket at 2554.

Haley's letter further advised the Commission that in order to produce the cost calculation, it would require significant work by Plan administrators and SIAC staff. (Ex. 1A at 4; Ex. 19.) Determining which prior period costs would qualify for GAAP treatment would require an exercise in judgment as the CTA's accounting did not follow GAAP. (Tr. 19-20, 430-31; Ex. 1A at 4; Ex. 19.)

Example Describing the New Entry Fee Calculation

Haley's letter to the Commission attached the Example as an exhibit. (Ex. 1A; Ex. 19.) It is titled "Example Illustrating Hypothetical Calculation of CTA/CQ Participation Fee for 2004." (Ex.1A; Ex. 19.) The Example was intended to be a transparent cost calculation as a letter to the Secretary of the SEC noted that, "The Participants intend that the [Example] methodology satisfies the SEC's staff request for an objective, purely mathematical, transparent calculation." (Ex. 1A at 4; Ex. 19 at 4.) It demonstrates how the CTA would set out development and production costs for five years along with a Consumer Price Index (CPI) adjustment. (Ex. 1A; Ex. 19.) The CTA states that the Example was developed in consultation with the Division. (Tr. 24-25.) The Division received a copy of the Example; however, it did not request the Example nor did the Division provide input on its contents. (Division's Amicus Brief at 6-7.) The Example does not appear in the amended language to the Plan nor was it published for comment in the Federal Register in early January 2005. (Division's Amicus Brief at 7.)

Lopez received a copy of the Plan amendment "without enclosures" on or about December 7, 2004. (Tr. 53-54.) He provided copies of the November 29, 2004, e-mails (Ex. 17, Ex. 18.) and Haley's letter (Ex. 1A; Ex. 19.) to legal and business officials at Nasdaq that may be affected by changes in the Plan language. (Tr. 71, 84.) After receiving a copy of the Example, Lopez did not object to any of the line items on it. (Tr. 82-83.) Further, he is not aware of anyone from Nasdaq ever objecting to the line items set forth in the Example before the entry fee calculations were actually done. (Tr. 83.) Because the Commission did not file the Example along with the Plan amendment for comment in the Federal Register, Lopez believes that is the reason Nasdaq did not formally comment on it. (Tr. 54-55.) Lopez recalled that he may have discussed with Haley that the Example was only hypothetical and actual numbers had to be produced before the Example would mean anything. (Tr. 55.) Lopez could not understand what was behind the numbers in the Example because there was no explanation of how they were

derived. (Tr. 55-56.) The only explanation offered was that SIAC was working diligently and having difficulty putting “numbers” in the cost buckets. (Tr. 56.)

Commission Approves the Amended Plan

On March 17, 2005, the Commission approved the proposed changes to the criteria used to calculate the new participant entry fee. See 84 SEC Docket 4136. The Commission’s discussion in the Adopting Release highlighted that, under the Plan amendment, the new entry fee should not consider or include “subjective or intangible costs such as good will [sic].” Id. at 4138. Further, the Commission noted that the main purpose of the entry fee is to require new participants, “to pay a fair share of the costs previously paid by the CTA for the development, expansion, and maintenance of CTA’s facilities.” Id. The Adopting Release specifies that the entry fee calculation should only consider expenditures that could have been capitalized under GAAP and prescribes that all capital assets acquired will be deemed to have a five-year useful life for the purposes of calculating the entry fee. Id. The Commission further stated that the entry fee must not include “any historical cost of operating the systems prior to the time a new party joins the Plans.” Id. No mention was made of the Example.

Calculation of New Participant Entry Fee

CTA Proposes Entry Fee Based Upon the Plan’s New Criteria

During the middle of 2005, after approval of the entry fee criteria, SIAC employees analyzed the total production and development costs to determine which costs to include as part of the new participant fee calculation. (Tr. 192-93, 197-98.) The analysis of SIAC’s cost records was performed primarily by Alyssa Schoenfeld (Schoenfeld)⁷ and Melissa Carinante (Carinante)⁸. (Tr. 193.) The analysis was performed over a period of approximately two months. (Tr. 193-94.) Detailed financial information from the SIAC general ledger was analyzed to identify costs categorized as development or expansion as opposed to maintenance or operations. (Tr. 197.) SIAC employees further analyzed the development and expansion costs in order to determine which of these costs could be capitalized under GAAP. (Tr. 200.) As they were instructed, in calculating the entry fee, Schoenfeld and Carinante used the language in the Plan and the Example as the criteria for establishing the new participant fee. (Tr. 194.)

During a meeting of the Operating Committee held on October 12, 2005, a four page chart of the CTA new entrant fee incorporating the new participant fee criteria was presented. (Ex. 6 at 4, Ex. 7.) The chart includes two types of costs: production costs and development costs, because SIAC only maintains its books and records in these two major categories. (Tr. 236, 383.) Production costs are ongoing year-to-year costs while development costs are

⁷ Schoenfeld is a managing director in corporate planning for NYSE Euronext, the parent company of SIAC. (Tr. 188.) She worked at SIAC from 1997 through December 2006. (Tr. 190.) She is a licensed CPA and worked for Arthur Andersen for three years after obtaining her college degree in 1990. (Tr. 191-92.)

⁸ Carinante was a business analyst at SIAC and was familiar with the CTA. (Tr. 193.)

discretionary, incremental costs to support specific initiatives. (Tr. 236-37, 384.) This is how SIAC reported the costs to the CTA. (Tr. 272.) Faughnan conducted the presentation. (Tr. 360-62.) He had been involved in calculating the new participant fee since 2004. (Tr. 327.) SIAC calculated the new participant fee at \$947,035. (Ex. 7.) The new participant fee is based upon certain CTA costs for the five-year period 2000 through 2004. (Ex. 7.) No work papers were provided in support of the calculation. (Tr. 61.) However, Faughnan testified that no Participant at the October 12 meeting, including Lopez, requested additional supporting documentation used in calculating the new participant fee. (Tr. 362.)

The first page of the chart is a cover sheet. (Tr. 60; Ex. 7.) The second page provides a quotation of the entry fee language from the Plan. (Tr. 60; Ex. 7.) The third page contains short descriptions of the costs that were included and excluded from total Plan costs and used to further calculate the entry fee. (Ex. 7.) The included costs consist of direct labor, data processing and communications equipment leases, shared data center resource usage associated with development or testing, and depreciation and amortization. (Ex. 7.) Direct labor was further broken down as development and product planning, communications engineering, quality assurance analysts, and test systems. (Ex. 7.) The excluded costs were indirect labor and related costs, data processing expenses associated with on-going operations, shared data center resource usage associated with on-going operations, costs associated with corporate support functions such as security, facilities, human resources, legal, finance, audit and administrative systems. (Ex. 7.) The fourth page of the chart consists of a schedule that shows included and total development costs along with included and total production costs from 2000 to 2004. (Ex. 7.) The chart also displays a total column for the five-year period. (Ex. 7.) The total Plan costs for the five-year period ended December 31, 2004, are \$30,224,363. (Ex. 7.) Of this amount, \$6,926,398 and \$23,297,965 are development and production costs, respectively. (Ex. 7.) However, development and production costs included in the fee calculation are \$4,924,775 and \$9,172,212, respectively. (Ex. 7.)

The included development costs and production costs are subject to amortization over a five-year period using the half-year convention.⁹ (Ex. 7.) Thus, the cumulative amortization expense for year-2000 costs is calculated at ninety percent of the total included costs for that year. A similar calculation is completed for each year with cumulative amortization of seventy, fifty, thirty and ten percent for years 2001 through 2004. (Ex. 7.) The calculated amortization expense for each year is further adjusted by the CPI. (Ex. 7.) The inflation indexing has the effect of increasing the amortization expense for each year presented. For example, the base amount for the year 2000 is increased by approximately thirteen percent. (Ex. 7.) The total of the amortization of the included inflation-indexed costs for the five-year period is approximately \$9.5 million. (Ex. 7.) This amount is divided by ten which corresponds to nine existing Participants and the new entrant. (Ex. 7.) The chart generally followed the Example previously provided to the Participants and the Commission. (Ex. 1A.)

⁹ The half-year convention assumes that capitalized assets were added evenly during the year and results in depreciation for the year equal to one half times the annual rate. See Patrick Delaney et al., Wiley GAAP 2002: Interpretation and Application of Generally Accepted Accounting Principles 351 (2001).

Lopez stated that Nasdaq did not have any input into selecting the included or excluded cost items. (Tr. 61.) “SIAC didn’t keep its books in a fashion that led to a readily discernable way to peel out things that might be pure operational compared to something else.” (Tr. 66.) He understood that production costs were not synonymous with operating costs; rather, production costs were a mix of operating and capital expenditures. (Tr. 78-79.) The CTA’s costs were not broken into categories such as development, maintenance, and expansion. (Tr. 100.) Lopez knew from Faughnan’s presentation that SIAC excluded various kinds of operating expenses from its entry fee calculations, but he was still unable to determine from the presentation, or the documents provided, what costs paid by the CTA were included or excluded. (Tr. 93-95, 98.)

Production Costs and Development Costs

In a November 2005 memorandum to the CTA Operating Committee Chairman, Tom Knorring, Nasdaq expressed concern that production costs included in the draft entry fee are more akin to operating costs and should not be included in the calculation. (Tr. 62-63; Nasdaq App. Br. Ex. 5.) In another memorandum to the Operating Committee, dated March 10, 2006, Nasdaq again expressed the view that production costs are impermissible operating costs and should be stricken from the fee calculation. (Ex. 13.) Nasdaq was concerned with the production cost category because of the difficulty of identifying operating costs included in that category. (Tr. 65-66.) Nasdaq’s concern is that if prior operating costs are included in the entry fee, a new entrant would pay for things the CTA already consumed and this would not be fair to the new entrant. (Tr. 65-66.) However, Nasdaq offered no evidence on this point.

Both Schoenfeld and Faughnan testified that production costs are not solely operating costs. (Tr. 236-37, 384.) Schoenfeld explained that production costs include development, expansion, and operating costs, such as payroll expenditures, lease expenditures for hardware and equipment, and depreciation and amortization of leasehold improvements from SIAC. (Tr. 250-55.) The payroll expense in production costs includes software developers, programmers, product planners, and communications engineers. (Tr. 250.) Development costs include lease expenditures for data processing and communications equipment and overhead such as finance, legal, utilities, and miscellaneous support functions. (Tr. 249, 273-74; Ex. 30.)

Costs Included and Excluded in Fee Calculation

Direct labor costs account for approximately seventy-seven percent of the included costs incorporated in the final entry fee calculation.¹⁰ (Ex. 30.) In order to determine which labor costs could be capitalized and included in the entry fee calculation, SIAC relied upon the accounting guidance contained in Statement of Position 98-1¹¹ (SOP 98-1). (Tr. 213.) SOP 98-1 provides guidance with respect to capitalizing costs incurred in creating internal use software.

¹⁰ The final entry fee calculation was performed in March 2006 and is supported by figures included in Exhibit 30. (Tr. 382.)

¹¹ Accounting for the Cost of Computer Software Developed or Obtained for Internal Use, Statement of Position 98-1 (Accounting Standards Executive Committee, American Institute of Certified Public Accountants 1998) AICPA Technical Practice Aids (June 1, 2007).

(Tr. 213.) SOP 98-1 permits labor costs for employees working directly on a software project to be capitalized in certain circumstances. (Ex. 9.) SIAC based its decision to capitalize labor costs primarily upon job function and the general nature of an employee's job. (Tr. 215-16.) SIAC did not identify what employees were working on by day, by person, or by timesheet. (Tr. 373.)

The other major category of included costs is lease expenditures for data processing and communications equipment, as CTA leases substantially all of its computer and communications hardware. (Tr. 81, 248; Ex. 30.) Equipment lease expenditures totaling \$3.4 million constitute approximately twenty-one percent of included costs in the entry fee calculation. (Tr. 273; Ex. 30.) Schoenfeld's understanding for including the lease expenditures is that if the hardware had been purchased it would have been capitalized and included in the entry fee calculation. (Tr. 223.) Therefore, excluding the lease payments would penalize the CTA for leasing the equipment rather than purchasing it. (Tr. 223.) Schoenfeld also noted that if the lease payments were not included in the fee calculation, the new participant would receive a windfall as it would not pay for any computer facilities of the CTA. (Tr. 223-24.) For the calculation, Schoenfeld relied upon the Example and footnote 20 to the Adopting Release.¹² (Tr. 220-21.) Depreciation of \$219,000 is also an included cost. (Ex. 30.) The depreciation relates to improvements made at the data centers by SIAC. (Tr. 216.)

Use of Consumer Price Index Inflator in the Calculation of the Entry Fee

The calculation of the new participant fee in the Example incorporates the use of the CPI to adjust certain historical amounts. (Tr. 24, 152, 201; Exs. 7, 15, 30.) In its March 10, 2006, memorandum to the Operating Committee, Nasdaq states that "the CTA Plan does not permit the use of a CPI inflator to increase SIAC's expenditures during the past five years and Nasdaq views the use of any inflator as inappropriate." (Ex. 13.) At the CTA meeting held on March 23, 2006, Nasdaq representative, James Brooks (Brooks), raised several issues among which was the use of the CPI. (Tr. 141.) The CTA believes that it is appropriate to take the time value of money into account because the fee calculation includes only the amortized portion of the includable expenses. (CTA Post-Hearing Br. at 21.)

Discussion of the Entry Fee after Nasdaq Joins CTA

On November 4, 2005, Nasdaq formally requested entry into the CTA. (Nasdaq App. Br. Ex. 5.) In its memorandum requesting entry, Nasdaq expressed concern that the fee was

¹² Footnote 20 to the Adopting Release approving the Plan amendment states, "The Commission understands from the Participants and the Plan Processor that based on how the Processor bills the CTA and because the Processor does its accounting based on leases rather than ownership of CTA facilities, unless such costs were deemed to be capitalized costs under GAAP, they could not otherwise be considered in calculating the participation fee. Footnote 12 of the [Federal Register] Notice provided, in part, that the Participants should only consider tangible assets that 'are capital expenditures under GAAP' in the participation fee calculation. The footnote should have instead provided that the costs to be included in the calculation should be those that 'could have been treated as capital expenses under GAAP.'" 84 SEC Docket 4136, 4138 n. 20.

excessive and was not properly calculated in accordance with the Plan's criteria. (Nasdaq App. Br. Ex. 5.) Nasdaq was concerned that certain costs included in the proposed entry fee were more akin to operating expenses and should not be included in the calculation. (Tr. 63; Nasdaq App. Br. Ex. 5.) Nasdaq requested that its representatives be allowed to meet with SIAC in order to determine the expenses included in the costs used to prepare the proposed entry fee of \$947,035. (Nasdaq App. Br. Ex. 5.) Subsequent to Nasdaq's request, at the meeting of the Operating Committee held on December 5, 2005, Brooks again advised that Nasdaq wanted more details about the cost items SIAC included in the calculation of the entry fee. (Ex. 8. at 2.) Faughnan noted that the fee was calculated in accordance with the Plan amendment but he would review the calculation, note which expenses were included in the calculation, and circulate the information. (Ex. 8 at 2.)

At the Operating Committee meeting held on January 20, 2006, the Participants discussed the report of SIAC's internal audit department concerning the new participant entry fee. (Ex. 10. at 1-2.) SIAC's internal audit department performed an agreed-upon-procedures engagement, "in order to validate the assumptions used in the calculation of the Participation Fee." (Ex. 9 at 1.) As part of the review, Schoenfeld provided work papers to internal audit employees. (Tr. 204-06.) The report notes that, "It was agreed that we would not examine the underlying detailed expenses or perform any detailed testing of specific cost categories." (Ex. 9. at 1) The procedures performed included recalculating the amounts included in the worksheets and schedules and analyzing the costs to ensure that they were properly characterized in accordance with the Plan language. (Tr. 263-64.; Ex. 9 at 3.) The report provides a description of costs that can be capitalized under GAAP including a brief summary of SOP 98-1. (Ex. 9 at 2.) The conclusion of the report is that the costs and assumptions used in the preparation of the entry fee of \$947,035 were reasonable. (Ex. 9 at 3.)

On February 2, 2006, SIAC and Nasdaq accountants and representatives participated in a conference call concerning the entry fee calculations. (Tr. 365-67.) Schoenfeld, Carinante, and Marc Liebman, the head of SIAC internal audit, were on the call. (Tr. 366.) Brooks and Nasdaq accounting personnel were also on the call. (Tr. 366.) Faughnan presented a revised entry fee schedule that was e-mailed to Nasdaq prior to the call. (Tr. 368; Ex. 12 at 6.) Faughnan did most of the talking on behalf of SIAC; Schoenfeld also added to the discussion. (Tr. 370-71.) Faughnan reviewed the schedule and went item by item and explained why each item was included. (Tr. 368-73; Ex. 12 at 6.) During the call, Nasdaq asked questions about the direct labor and data processing line items. (Tr. 372.) Nasdaq did not request any documentation further explaining or supporting the entry fee. (Tr. 371.)

During the call, Nasdaq asked SIAC to look under the Production category at the Direct Labor line item and to "fine tune" the cost component called "development". (Tr. 372.) Over the course of the week following the conference call, Faughnan worked with development director, Robert Rusker, to identify which development activities could be further broken down into support activities and development activities. (Tr. 372.) The result of Faughnan's additional analysis was that development labor costs included in the entry fee were reduced by thirty-five percent. (Tr. 373.) This refinement was included in the entry fee schedule that was presented at the next meeting of the Operating Committee held on February 9, 2006. (Ex. 11 at 3; Ex. 12 at 5.)

At the Operating Committee meeting held on February 9, 2006, the Participants reviewed a revised entry fee schedule. (Tr. 135-138; Ex. 11 at 3; Ex. 12.) The revised entry fee established on February 6, 2006, was \$912,918, which was a reduction of \$34,117 from the original entry fee of \$947,035. (Tr. 138; Ex. 12 at 5.) The reduction in the entry fee is due to two items. The spreadsheet that computed the original entry fee contained a mathematical error that excluded the development costs incurred in 2004 from the total costs. The correction of this error resulted in an increase of \$4,469 in the original fee. The second item is an adjustment to the labor costs included as part of the entry fee. SIAC determined that a portion of the work performed by their developers for the CTA is break/fix work that involved programming required to correct problems. (Tr. 279.) The break/fix work is considered maintenance work and cannot be capitalized under GAAP. (Tr. 279.) This refinement in SIAC's analysis of development costs meant that only sixty-five percent of the development labor in the production category could be capitalized. (Tr. 373.) The refinement to the labor costs resulted in a decrease in the original entry fee of \$38,586 resulting in a revised entry fee of \$912,918. (Ex. 12 at 5.)

In a memorandum dated March 10, 2006, Nasdaq advised the Operating Committee that it joined the CTA and was eager to resolve the issue of the new participant fee. (Ex. 13.) The memorandum raised several issues regarding the calculation of the fee and concluded that it should be \$283,975. (Ex. 13.) Nasdaq noted that it calculated the new participant fee based solely upon development costs as it did not believe that production costs should be included. (Ex. 13.) Production costs accounted for approximately \$600,000 of the \$912,918 revised new participant fee presented at the February 2006 meeting. (Ex. 12 at 5.) The remaining difference between the revised new participant fee and the Nasdaq proposal is the CPI adjustment to the development costs of approximately \$29,000. (Ex. 12 at 5.)

At the meeting of the Operating Committee held on March 23, 2006, the Participants addressed the new participant fee once again. (Tr. 140-141; Ex. 14 at 2-3.) Brooks "raised several issues regarding the costs to be included in the calculation," and proposed that the Nasdaq pay a new participant fee of \$283,975. (Tr. 141; Ex. 14 at 2-3.) Brooks moved to adopt the new participant fee of \$283,975, but there was no second to the motion and no vote. (Tr. 141; Ex. 14 at 3.) Another Participant moved for a fee of \$833,682 for Nasdaq and another new participant, the ISE. (Tr. 141; Ex. 14 at 3.) This motion was approved. (Tr. 141-142.) The approved new participant fee of \$833,682 decreased the February 2006 proposal by \$79,236. (Ex. 12, Ex. 15 at 6.) This decrease resulted from using the CTA costs incurred from 2001 to 2005 rather than 2000 to 2004. This resulted in a decrease of \$39,537 in the \$912,918 Nasdaq fee. The remaining decrease was due to the entry of the ISE, which was shortly after the entry of Nasdaq. (Ex. 12, Ex. 15.)

The Operating Committee calculated a separate entry fee for the ISE in the amount of \$793,983 based upon eleven participants. (Ex. 15 at 7.) The Operating Committee then calculated the average of the fees for the tenth (Nasdaq) and eleventh participant (ISE) in order to arrive at the entry fee of \$833,682 for both Nasdaq and ISE. (Tr. 21; Ex. 14 at 3; Ex. 15 at 4.) The approved new participant fee of \$833,682 decreased the February 2006 proposal of \$912,918 by \$79,236. (Ex. 12, Ex. 15 at 6.) At the Operating Committee meeting held on May

10, 2006, the Participants agreed that the entry fee should be paid in two equal payments. (Ex. 16 at 5.) They also agreed that the entry fee proceeds would be distributed to the Participants based upon their individual market share. (Ex. 16 at 6.) The ISE paid the full fee and Nasdaq paid one half.

CONCLUSIONS OF LAW

In 1975, Congress enacted Exchange Act Section 11A to facilitate the establishment of a national market system for securities. Securities Act Amendments of 1975, Pub. L. 94-29, 89 Stat. 97 (1975) (Section 11A is codified at 15 U.S.C. § 78k-1 (2005)). An integral part of the national market system is the establishment and operation of an exclusive processor of market information. The collection and publishing of accurate and timely market data is considered critical to the functioning of the securities markets. In adopting Section 11A, Congress gave the SEC “broad powers over any exclusive processor and impose[s] on that agency a responsibility to assure the processor’s neutrality and the reasonableness of its charges in practice as well as in concept.” Securities Acts Amendments of 1975, Report of the Senate Committee on Banking, Housing and Urban Affairs, S. Rep. 94-75, at 12 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 190; see also Bradford Nat. Clearing v. SEC, 590 F.2d 1085, 1094-1095 (D.C. Cir. 1978) (“It [Congress] provided the Commission with ‘intentionally broad’ and ‘clear power’.”)

The current matter is instituted under Exchange Act Section 11A(b)(5) and Rule 608(d). The Commission is asked to review the decisions of the CTA with respect to the calculation of the new participant entry fee. The Commission has previously concluded that fees and/or the amount charged by a registered securities information processor can be a prohibition or limitation on access to facilities or services of the processor. See Cincinnati Stock Exch., 54 S.E.C. 857, 861 (2000); Nat’l Mkt. System Securities, 30 SEC Docket 435, 439-40 (Apr. 17, 1984); Institutional Networks Corp., 28 SEC Docket 980, 982 (Aug. 16, 1983); Bunker Ramo Corp., GTE Information Systems Inc., Options Price Reporting Authority, 16 SEC Docket 285, 287 (Nov. 29, 1978).

If the prohibition or limitation is consistent with the Exchange Act and does not unfairly discriminate or pose an unnecessary burden on competition, the Commission shall dismiss the proceeding. See 15 U.S.C. § 78k-1(b)(5)(B). However, if the Commission finds that the prohibition or limitation is not consistent with the Exchange Act and unfairly discriminates against the aggrieved party, or imposes a burden on competition, the Commission shall set aside the prohibition or limitation. See 15 U.S.C. 78k-1(b)(5)(B). Based upon this record, I conclude that, with some adjustments discussed below, the new participant entry fee calculation by the CTA is consistent with the Exchange Act, does not unfairly discriminate, and is not an undue burden on competition.

The relevant provisions of the new participant fee included in Section III(c)(2) of the CTA Plan approved by the Commission are:

(2) “Participation Fee”. In determining the amount of the Participation Fee to be paid by any new Participant, the Participants shall consider one or both of the following:

the portion of costs previously paid by the CTA for the development, expansion and maintenance of the CTA’s facilities which, under generally accepted accounting principles, could have been treated as capital expenditures and, if so treated, would have been amortized over five years preceding the admission of the new Participant (and for this purpose all such capital expenditures shall be deemed to have a five-year amortizable life); and

previous Participation Fees paid by other new Participants.

(Ex.1 at 3.)

The Adopting Release notes the Division’s concern that the participation fee “should be based solely on objective criteria and costs that could be easily calculated and readily discernable.” See 84 SEC Docket at 4137. The Adopting Release also provides clear language that the new criteria require new participants “to pay a fair share of the costs previously paid by the CTA for the development, expansion, and maintenance of [the] CTA’s facilities.” *Id.* at 4138. Consistent with that mandate, the Adopting Release provides specific guidance that the only costs that should be considered are “the costs of tangible assets that could have been treated as capital expenditures under GAAP.” *Id.* A new participant fee that does not comply with the amendment criteria could result in a fee that attempts to recover inappropriate costs.

Costs Included in the New Participant Entry Fee as Calculated by SIAC

The amendment states that the new participant fee can include any cost that could have been treated as a capital expenditure.¹³ However, the evidence establishes that SIAC did not keep its books in accordance with GAAP. (Tr. 210.) Nothing in SIAC’s books and records readily identifies which costs were incurred solely in developing, enhancing, or operating the system. (Tr. 19, 236-37, 384.) To calculate the new participant fee, and to comply with the Plan rules, SIAC had to perform additional analysis of its books and records in order to identify costs that are appropriately included in the new participant fee. (Tr. 19.) Much of this analysis was performed by Schoenfeld, who is an experienced CPA and familiar with the applicable

¹³ In discussing the amendment, Faughnan advised Haley that the language was not clear and needed the Example to explain the calculation. (Tr. 329.) Lopez agreed that the amendment’s language was not clear and needed the illustration to clarify it. (Tr. 73-75.) Haley directed that the Example be used in the fee calculation. (Tr. 194.) Therefore, Schoenfeld followed the amendment language and the Example. (Tr. 194, 215.) Although the Example was not specifically commented upon by the Commission, Nasdaq received a copy of it in 2004, well before the new participant fee was approved in March 2006. (Tr. 53-54; Ex. 1A; Ex. 14.)

accounting guidance. (Tr. 188-92.) Schoenfeld and her assistants spent about two months analyzing the books of SIAC to identify costs that could be included in the new participant fee. (Tr. 193-94.) Given Schoenfeld's experience as a CPA and extensive knowledge of the CTA's operations, I ascribe significant weight to her analysis.

Most of the costs included in the new participant fee are direct labor costs that could have been capitalized under SOP 98-1, as Schoenfeld understood. (Tr. 214.) This included labor costs associated with software development which meant, in some cases, labor costs were allocated for workers whose daily activities involved operating the system as well as developing and enhancing it. (Tr. 19-20, 210-13; Ex. 30.) The internal audit group of SIAC performed agreed upon procedures that reviewed the relevant accounting principles used in compiling the new participant fee and concluded that the costs and assumptions used were reasonable. (Ex. 9. at 3.) However, the record also establishes that a significant amount of labor costs, such as computer operator costs, were excluded from the fee. (Tr. 312.) Faughnan testified that he and the development director went through the activities of SIAC in order to identify "which activities were development and which were more of a day-to-day correction or maintenance type activity." (Tr. 372-73.) Faughnan testified that SIAC took a "practical, realistic approach to determine which manpower categories could be included." (Tr. 430.)

Nasdaq's accountants had an opportunity to inquire of SIAC representatives about the fee calculation in a telephone conference call on February 2, 2006. (Tr. 365.) Their questions were answered and Nasdaq representatives did not ask for any additional documentation supporting the calculation of the entry fee during the call. (Tr. 371.) However, after the call, SIAC adjusted the amount of development labor that was to be a capital expenditure from one hundred percent to sixty-five percent. (Tr. 372-77.) Accordingly, these labor costs are based upon a thorough analysis of the books and records, and I conclude that they are properly included in the fee.

The new participant fee also included lease expenditures. (Tr. at 273.) Schoenfeld reviewed the information that supported SIAC's billings to the CTA for the five-year period, 2000-04. (Tr. 196.) In compliance with the amendment language, Schoenfeld then determined which costs could be considered as development or expansion, and therefore able to be capitalized, as opposed to periodic costs that were for maintenance and operation which could not. (Tr. 197-98.) Development activities were those that added new features or functionality to the CTA's facilities allowing the CTA to perform tasks beyond what it could previously do. (Tr. 219, 338.) Expansion activities were those that increased the capacity or bandwidth of the CTA's computer facilities. (Tr. 338.)

Schoenfeld testified that the leases were for high capacity computers that are "the engine for [the] CTA." (Tr. 218-19.) Her understanding was that the Commission recognized that if the computers had been purchased, they could have been capitalized under GAAP and were therefore includable in the fee calculation. (Tr. 220-22.) In support of its position that lease expenditures should be included in the entry fee, the CTA relies upon the language in footnote 20 to the Adopting Release which states that the costs to be included in the participant fee calculation should be those that "could have been treated as capital expenses under GAAP". (CTA Post-Hearing Br. at 24.) Therefore, I credit her testimony that, in addition to following the amendment language and the Example that illustrated the included costs, the lease costs and

other remaining production and development costs are appropriate for inclusion in the new participant entry fee.¹⁴

The Use of a CPI Adjustment

Nasdaq has alleged that the inclusion of a CPI adjustment, which increased the new entrant fee by about \$72,000, is improper. (Tr. 21.) Neither the Plan nor the Adopting Release includes a CPI adjustment or any other price index adjustment. The Adopting Release specifically mentions that costs to be considered should be costs that can be recognized under GAAP. However, GAAP does not recognize the use of price level indexing. See Financial Reporting and Changing Prices, Statements of Financial Accounting Standards No. 89 (Financial Accounting Standards Bd. 1986), Original Pronouncements (June 1, 2007). I find that use of the CPI adjustment is not in accordance with the Plan and the new participant fee should be recalculated without the adjustment.

Averaging the Entry Fee of the Tenth and Eleventh Participant

Although Nasdaq and the ISE joined the Plan close in time, Nasdaq has alleged that it was improper to average the entry fee between the tenth Participant (Nasdaq) and eleventh Participant (ISE). (Tr. 22.) The minutes of the May 10, 2006, CTA meeting state that the new entrant fee is “merely a cost recovery exercise.” (Ex. 16 at 5-6.) Therefore, if Nasdaq is considered the tenth Participant, then its participation fee would have paid some of the prior costs of the CTA. As such, when the ISE paid its fee as the eleventh Participant, Nasdaq should have received part of the ISE fee as reimbursement for Nasdaq’s prior payment of the CTA costs. The net effect would have been similar to treating both the Nasdaq and the ISE as the eleventh Participant. To further explain, assume a pool of costs in the amount of \$1 million that was funded by nine partners. Further assume that a tenth partner was invited to join the partnership. The entry fee for the partnership is one tenth of the \$1 million or \$100,000. Each of the original nine partners splits the \$100,000 nine ways. Then an eleventh partner is invited to join the plan. This partner has to pay one eleventh of the \$1 million cost pool. Each of the prior ten partners split the entry fee of \$90,900. The tenth partner paid \$100,000, then receives \$9,100 from the eleventh partner for a net payment of \$90,900. Thus, the tenth and eleventh partner pay the same amount. Accordingly, I conclude that both the Nasdaq and the ISE should have both paid the new entrant fee as if they were both the eleventh Participant and the new entrant fee should be recalculated accordingly. The CTA noted that they treated Nasdaq and the ISE as the “tenth-and-a-half participant.” (Tr. 25.)

CERTIFICATION OF THE RECORD

Pursuant to Rule 351(b) of the Commission’s Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the record index issued by the Secretary of the Commission on April 1, 2008.

¹⁴ The Example included a line titled, “portion of production costs representing amortization had CTA/CQ Participants capitalized hardware leases....” (Ex. 18 at 4.)

ORDER

Based on the findings and conclusions set forth above:

IT IS ORDERED THAT the new participant entry fee calculated by the Consolidated Tape Association on March 23, 2006, be, and hereby is, set aside;

IT IS FURTHER ORDERED that the Consolidated Tape Association calculate the new participant entry fee by treating The NASDAQ Stock Market, LLC and the International Securities Exchange each as the eleventh participant;

IT IS FURTHER ORDERED that the Consolidated Tape Association calculate the new participant entry fee without incorporating any additional fee amount attributable to the Consumer Price Index.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practices, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact, or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Robert G. Mahony
Administrative Law Judge