THE NASDAQ STOCK MARKET
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May 18, 2007

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F. Street N.E
Washington, D.C. 20549

Re: In the Matter of NetCoalition, File No. SR-NYSEArca-2006-21

Dear Ms. Morris:

The NetCoalition Petition challenging the Division of Market Regulation's approval of SR-NYSEArca-2006-021 has sparked an unfocused debate over the standard of Commission review of fees that national securities exchanges charge for market data. The cause of the confusion is simple: the Petition ignored the simple but critical fact that there are two very different categories of market data - *consolidated* data and *proprietary* data - and that each requires different treatment under the Securities Exchange Act of 1934 ("Exchange Act").

Consolidated and proprietary data products differ in every material respect, from the data they contain to how they are produced, how they are distributed, by whom they are consumed, and for what purposes. Most importantly, proprietary data is produced in a vibrantly competitive environment, whereas the consolidated data for a given security is produced exclusively by a single government-mandated consortium. In light of these differences, the fees assessed for consolidated and proprietary data demand separate and distinct treatment under the Exchange Act, including a different standard of Commission review of fee proposals. The Petition ignored these differences and erroneously urged the Commission to review the fee for a proprietary data product (NYSEArca Inc.'s proprietary depth-of-book data) as though it were a consolidated one.

Below, Nasdaq describes the two categories of data and how they came to co-exist within the national market system, states the rationale for treating consolidated and proprietary data differently, and demonstrates that the market for proprietary data products is inherently competitive because the purchase of proprietary products is completely voluntary, multiple distributors of proprietary data already exist, and market entry is rapid, inexpensive, and profitable. Based upon the contestable nature of the

market for proprietary data products, Nasdaq suggests that the Commission should defer to competitive market forces and determine that the fee an exchange sets for its own proprietary data is presumptively reasonable. A deferential standard of this nature is supported—indeed, required—by the structure and history of the Exchange Act; by the Commission's regulations; and by sound public policy.

Nasdaq hopes that the analysis in this letter will assist the Commission not only as it considers the issues raised by NetCoalition's Petition with respect to NYSEArca, Inc.'s proposed fee but also as the Commission considers Nasdaq's pending proposed rule changes regarding its depth-of-book and last-sale data products.

The Petition Ignores That Consolidated and Proprietary Data Differ In Every Material Respect

Consolidated Data consists of two data elements reflecting quoting and trading activity in securities traded on multiple markets: (1) the best bid and offer from each exchange and the NASD as well as the combined national best bid and offer for each security (collectively referred to as the "NBBO"), and (2) the combined last sale price for each security. Consolidated data is a construct of the 1975 Amendments to the Exchange Act which were based on the principle that not only must quotation and transaction information from each market be accessible to investors, but that information must be available in a consolidated data stream. Congress and the Commission have continually reaffirmed that the wide availability to investors of consolidated quotes and transaction reports from all the market centers that trade a security is an essential element of a truly "national" market system. As this Commission noted in proposing Regulation NMS, consolidated data "is the principal tool for assuring the transparency of buying and selling interest in a security, for addressing the fragmentation of trading among many different market centers, and for facilitating the best execution of investor orders by their brokers."

Consolidated data is produced by regulatory compulsion. Section 11A and Rule 603 of Regulation NMS compel the exchanges and the NASD to act jointly via national market system plans to produce consolidated data. Rule 603 compels each exchange and the NASD to provide its best bid and offer and transaction reports for each security to a single network processor which then consolidates that data to produce the NBBO and last sale data. Only network processors create and disseminate consolidated data; consequently all other market data, including the data that exchanges and broker-dealers produce, is proprietary.

Once produced, market data vendors are compelled by the Display Rule, Rule 603(c), to display consolidated data to investors at the point at which they wish to place buy and sell orders. In adopting Regulation NMS, the Commission reaffirmed the requirement that market data vendors must provide investors with access to both the NBBO and the consolidated last sale, although the Commission reduced the scope of consolidated data that vendors must display and the instances in which they must display it.

Exchanges and broker-dealers are also compelled to purchase and use consolidated data. Rule 611, the Order Protection Rule, requires firms to honor all protected quotes - the best bid and offer of each exchange and the best quote of all NASD participants - and firms must purchase and use the consolidated data to identify those protected quotes. Exchange execution systems also use consolidated data to comply with the Order Protection Rule. In addition, exchanges and broker-dealers use consolidated data in their surveillance and compliance systems to comply with multiple requirements of Regulation NMS.

Since the advent of consolidated data, the members of the national market system plans (all self-regulatory organizations or "SROs") have established fees for the consolidated data, and have shared the resulting revenue to pay a portion of their regulatory costs. Historically, consolidated data has been viewed as the most equitable way to spread the cost of the high Commission-imposed standards of SRO operational resiliency and regulatory oversight over the broadest population of beneficiaries. In fact, while the number of transactions flowing through SROs operational and regulatory systems has grown exponentially, the monthly fees for the data have remained constant, thus resulting in a 90% decline in the unit cost of consolidated data. The fee per million transactions has declined from nearly $0.20 in 2000 to less than $0.02 in 2006 for professional users, and from over $.0090 in 2000 to $0.0008 in 2006 for non-professional users.

Proprietary Data. If compulsion is the *sine qua non* of consolidated data, for proprietary data it is choice. Proprietary data is made available voluntarily and solely outside the strict confines of the national market system plans. Proprietary data also reflects quoting and trading activity in securities traded across markets, but it may contain any bids and offers, any last sale information, and any other market information that market participants can develop, unlike consolidated data which is strictly limited to the NBBO and the national last sale price. Proprietary optional data may be offered by a single broker-dealer, a group of broker-dealers, a national securities exchange, or a combination of broker-dealers or exchanges, unlike consolidated data which is only available through a consortium of SROs

No exchange, association or broker-dealer is required by any regulation to produce any proprietary data element or product. As a result, the act of producing it, the selection of data elements to be produced, and the method of distribution are all voluntary. Once proprietary data is voluntarily produced, market data vendors may voluntarily choose to display it or not to display it, individual investors may voluntarily choose to consume it or not to consume it, and broker-dealers too, voluntarily choose which if any proprietary data to consume.

In Approving Regulation NMS, the Commission Forcefully Directed That Competition Rather Than Regulation Must Govern the Production of and Demand for Proprietary Data Products

The Exchange Act makes clear that Congress, in the 1975 Amendments, intended for the Commission to promote a free, competitive market for market data to the maximum extent possible. Congress directed the Commission to facilitate the creation of a national market system for the trading of securities, and allow it to "evolve through the interplay of *competitive* forces as unnecessary regulatory restrictions are removed." *See* H.R. Rep. No. 94-229, at 92 (Conf. Rep.) (emphasis added). Moreover, the Amendments' legislative history reveals that Congress intended the Commission to balance the need to regulate *consolidated* data, with the need for competition in the market for *proprietary* data. Congress noted that market forces in some cases could be inadequate to discipline "the creation of a *composite* quotation system or a *consolidated* transactional reporting system." H.R. Rep. No. 94-229, at 92 (Conf. Rep.) (emphasis added).

Regulation NMS implements the free-market purposes of the 1975 Amendments. In adopting Regulation NMS the Commission stated that "[v]igorous competition among markets promotes more efficient and innovative trading services, while integrated competition among orders promotes more efficient pricing of individual stocks for all types of orders, large and small." The Commission sought to avoid the extremes of a fragmented marketplace where buyers and sellers could not execute orders at the best available prices and "a totally centralized system that loses the benefits of vigorous competition and innovation among individual markets." The Commission considered it vitally important that Regulation NMS strike the correct balance between these two broad purposes.

Regulation NMS achieved this balance in part by permitting exchanges to sell proprietary data separate from consolidated data, and by subjecting proprietary data to a minimal regulatory environment. The consolidated feed, the Commission explained, would continue to contain basic market data— the NBBO and consolidated last-sale. But "[b]eyond disclosure of this basic information, market forces, rather than regulatory requirements, will be allowed to determine what, if any, additional data from other market centers is displayed." For example, providers of optional proprietary data—such as depth-of-book data—"should have considerable leeway in determining whether, or on what terms, they provide additional, non-core data to a Network processor." These newly-relaxed requirements, the Commission made clear, "will allow market forces, rather than regulatory requirements, to determine what, if any, additional quotations outside the NBBO are displayed to investors." In other words, Regulation NMS implements the very distinction that Congress anticipated in enacting the 1975 amendments—that proprietary data will exist in a minimal regulatory environment.

Regulation NMS further underscored the distinction between consolidated and proprietary data in its Order Protection Rule. Prior to the Rule's adoption, the

Commission considered two possible order protection alternatives: a "Market BBO Alternative" that would only require exchanges to match the NBBO prices produced by the consolidated feed, and a "Voluntary Depth Alternative" that would require comparison to whatever full depth-of-book data exchanges decide to voluntarily disclose to the consolidated network. The Commission rejected the latter proposal, concluding that "the Market BBO Alternative will promote best execution for retail investors on an order-by-order basis, given that most retail investors [] justifiably expect that their orders will be executed at the NBBO." Furthermore, "implementation of the Market BBO Alternative will not require an expansion of the data disseminated through the Plans," which mandate only NBBO and last-sale prices. The Order Protection Rule ultimately adopted maintains a balance between competition for orders and competition among markets: while an integrated data product for NBBO and last-sale prices is needed to "promote [] more efficient pricing of individual stocks for all types of orders," direct competition in the creation and distribution of proprietary depth-of-book data products will "promote [] more efficient and innovative trading services."

Finally, the Commission concluded that Regulation NMS—by deregulating the market in proprietary data—would itself further the Exchange Act's goals of facilitating efficiency and competition:

> [The Rule] would allow investors and vendors greater freedom to make their own decisions regarding the data they need and . . . the proposal should lead to lower costs to investors. . . . [E]fficiency is promoted when broker-dealers who do not need the data beyond the prices, sizes, market center identifications of the NBBO and consolidated last sale information are not required to receive (and pay for) such data. The Commission also believes that efficiency is promoted when broker-dealers may choose to receive (and pay for) additional market data based on their own internal analysis of the need for such data.

By removing "unnecessary regulatory restrictions" on the ability of exchanges to sell their own data, Regulation NMS advanced the goals of the Exchange Act and the principles reflected in its legislative history.

Depth-of-Book Data Is Proprietary, Not Consolidated, and No Market Participant Is Required to Purchase Any Single Depth-of-Book Product.

Depth-of-book data is quintessentially proprietary. Depth-of-Book data reflects all of the quotations and orders currently residing within the execution systems of a single marketplace. There is no regulatory requirement that an exchange or other marketplace disseminate depth-of-book data, as evidenced by the fact that only recently have many markets chosen to offer a depth-of-book product and several still do not offer one. Depth-of-book data is disseminated outside the national market system plans by individual markets and market participants.

Despite the clear language and intent of Regulation NMS to deregulate the market for proprietary data products, such as depth-of-book data, the NetCoalition Petition and some commentors suggest that NYSEArca's proprietary depth-of-book data should be regulated as though it were consolidated data because without such data broker-dealers cannot meet their duties under Regulation NMS to execute orders at the best available prices. Neither Congress, nor the Commission, nor any self-regulatory organization has ***ever*** adopted a regulation that requires the production, consumption, or display of depth-of-book data, or any other proprietary data.

As detailed above, however, NetCoalition is mistaken that broker-dealers must acquire proprietary data to meet their regulatory obligations. On the contrary, Regulation NMS makes clear that *consolidated* market data, *not* proprietary market data, is all broker-dealers require to meet their order-protection obligations under Regulation NMS. Indeed, as discussed above, the Commission *specifically rejected* a proposal to require broker-dealers to compare the consolidated NBBO data to depth-of-book data. Broker-dealers therefore do not need to purchase proprietary data in order to fulfill their obligations under Regulation NMS.

Empirical sales data for Nasdaq TotalView, Nasdaq's proprietary depth-of-book data, demonstrate that broker-dealers do not consider TotalView to be required for compliance with Regulation NMS or any other regulation. As of April 30, 2007, over 420,000 professional users purchase consolidated (Level 1) data, but less than 19, 000 professional users purchased TotalView, less than five percent. As of that date, over 1,725,000 non-professional users purchased consolidated (Level 1) data but less than 12,000 non-professional users purchased TotalView – less than one percent.[1] On that date, only 20 broker-dealers or broker-dealer affiliates provided TotalView to more than 100 professional users. In other words, of the 735 broker-dealers members that trade Nasdaq securities, only 20 or 2.7 percent spend more than $7,000 per month on TotalView users. Nasdaq understands that firms with more than 100 TotalView professional users generally provide TotalView to only a small fraction of their total user populations. Broker-dealers may claim they are required to purchase TotalView, but their actions indicate otherwise.

In Nasdaq's experience, vendors offer depth-of-book data and users purchase it because depth-of-book data provides an economic benefit consistent with their chosen business model. The choice by an individual broker-dealer of one business model or another should not dictate Nasdaq's business model or its ability to assess a fee for its proprietary data. Moreover, the mere existence of a business model in which depth-of-

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1 Two entities purchase a TotalView non-professional enterprise license which enables them to provide TotalView to an unlimited number of non-professional users within a single entity. Based upon self-reports, those entities off TotalView to another 39,000 non-professional users, brining the TotalView non-professional user base to a potential high of 2.9 percent of all non-professional users of consolidated data.

book data offers value, does not establish that depth-of-book data is a regulatory requirement or, as described in more detail below, that there are no reasonable substitutes for any particular depth-of-book product. Nor does it establish that depth-of-book data or any proprietary data should be regulated as consolidated data.

The Market for Proprietary Products Is Currently Competitive and Inherently Contestable Because Entry Into the Market Is Rapid, Inexpensive, and Profitable

NetCoalition's "market power" argument rests on a premise that is transparently false: that the exchanges have "absolute market power" with respect to "their own sole source data." NetCoalition Letter (Mar. 6, 2007), at 6. That is a tautology that simply reflects the unexceptional point that each exchange, like any creator and disseminator of a proprietary good, has the exclusive right to set the price for its own product. The fact that each exchange sets the price for its own data no more means that the exchanges are "monopolies" than Ford or Honda are monopolies simply because they also have "absolute market power" with respect to "their own" automobiles.

The numerous market substitutes for each exchange's proprietary data, like the numerous substitutes for Ford and Honda automobiles, demonstrates that no individual exchange possesses a "monopoly" in such data. Numerous exchanges vigorously compete with each other for listings, trades, and market data itself, providing virtually limitless opportunities for entrepreneurs who wish to produce and distribute their own market data. This proprietary data is produced by each individual exchange, as well as other entities, in a vigorously competitive market, and is distinct from *consolidated* market data, which represents the collective product of trading on all the exchanges.

The attached depiction of the national market system (Exhibit A), graphically illustrates that the market for proprietary data products is currently competitive and inherently contestable because there is fierce competition for the inputs necessary to the creation of proprietary data and strict pricing discipline for the proprietary products themselves. Beginning at the top, broker-dealers currently have numerous alternative venues for their order flow, including eleven self-regulatory organization ("SRO") markets, as well as broker-dealers ("BDs") and aggregators such as the BATS electronic communications network ("ECN"). Each SRO market competes to produce transaction reports via trade executions, and an ever-increasing number of NASD-regulated Trade Reporting Facilities ("TRFs") compete to attract internalized transaction reports. It is common for BDs to promote and exploit this competition by sending their order flow and transaction reports to multiple markets, rather than providing them all to a single market. Competitive markets for order flow, executions, and transaction reports provides pricing discipline for the inputs of proprietary data products.

The large number of SROs, TRFs, and ECNs that currently produce proprietary data or are currently capable of producing it provides further pricing discipline for proprietary data products. As shown on Exhibit A, each SRO, TRF, ECN and BD is currently permitted to produce proprietary data products, and many currently do or have

announced plans to do so, including Nasdaq, NYSE, Amex, NYSEArca, and BATS. Any ECN or BD can combine with any other ECN, broker-dealer, or multiple ECNs or BDs to produce jointly proprietary data products. Additionally, non-broker-dealers such as order routers like LAVA, as well as market data vendors, can facilitate single or multiple broker-dealers' production of proprietary data products. The potential sources of proprietary products are virtually limitless.

The fact that proprietary data from ECNs, BDs, and vendors can by-pass SROs, as shown in Exhibit A, is significant in two respects. First, non-SROs can compete directly with SROs for the production and sale of proprietary data products, as BATS does today by publishing its proprietary depth-of-book data on the Internet. Second, because a single order or transaction report can appear in an SRO proprietary product, a non-SRO proprietary product, or both, the data available in proprietary products is exponentially greater than the actual number of orders and transaction reports that exist in the marketplace writ large.

Consolidated data, depicted on Exhibit A at the center of the national market system, provides two additional measures of pricing discipline for proprietary data products that are a subset of the consolidated data stream, such as last sale data. First, the consolidated data is widely available in real-time at low cost (for Nasdaq securities, $20 per month for professional users and $1 per month cap for non-professional users). Second, consolidated data is available ***at no cost*** with a delay of 15 minutes for Nasdaq securities (20 minutes for NYSE and Amex securities), as shown on Exhibit A by grey lines leading from consolidated data to data vendors. Because consolidated data contains marketwide information, it effectively places a cap on the fees assessed for proprietary data that is simply a subset of the consolidated data. The mere availability of low-cost or free consolidated data provides a different but no less powerful form of pricing discipline for proprietary data products that contain data elements beyond the NBBO and last sale, such as full-depth-of-book products, by highlighting the optional nature of proprietary products.

Market data vendors, such as those depicted along the bottom of Exhibit A, provide another form of price discipline for proprietary data products because they control the primary means of access to end users. Vendors impose price restraints based upon their business models. For example, vendors such as Bloomberg and Reuters that assess a surcharge on data they sell may refuse to offer proprietary products that end users will not purchase in sufficient numbers. Internet portals, such as Google and Yahoo, impose discipline by providing only that data which will enable them to attract "eyeballs" that contribute to their advertising revenue. Retail broker-dealers, such as Schwab and Fidelity, offer their customers proprietary data only if it promotes trading and generates sufficient commission revenue. Although the business models may differ, these vendors' pricing discipline is the same: they can simply refuse to purchase any proprietary data product that fails to provide sufficient value. Nasdaq and other producers of proprietary data products must understand and respond to these varying

business models and pricing disciplines in order to successfully market proprietary data products.

In addition to the competition and price discipline described above, the market for proprietary data products is also highly contestable because market entry is rapid, inexpensive, and profitable. The history of electronic trading is replete with examples of entrants that swiftly grew into some of the largest electronic trading platforms and proprietary data producers: Archipelago, Bloomberg Tradebook, Instinet, Island, RediBook, Attain, TracECN, and BATS Trading. Today, BATS publishes its depth-of-book data at no charge on its website in order to attract order flow, and it uses market data revenue rebates from the resulting executions to maintain low execution charges for its users. Several ECNs have existed profitably for many years with less than a five percent share of trading, including Bloomberg Tradebook and NexTrade.

Regulation NMS, by deregulating the market for proprietary data, has increased the contestability of that market. While broker-dealers have previously published their proprietary data individually, Regulation NMS encourages market data vendors and broker-dealers to produce proprietary products cooperatively in a manner never before possible. Multiple market data vendors already have the capability to aggregate data and disseminate it on a profitable scale, including Bloomberg, Reuters and Thomson. New entrants are already on the horizon, including "Project BOAT," a consortium of financial institutions that is assembling a cooperative trade collection facility in Europe. These same institutions are active in the United States and could rapidly and profitably export the Project BOAT technology to exploit the opportunities offered by Regulation NMS.

Like the market for electronic executions, the related market for proprietary data products is also influenced by the equity investments of major financial institutions in competing SROs. Many of Nasdaq major customers have equity investments in one or more exchanges, including the Boston Stock Exchange, Philadelphia Stock Exchange, NYSEArca Exchange, Chicago Stock Exchange, and NYSE. Equity investors control substantial order flow and transaction reports that are the essential ingredients of successful proprietary data products. Equity investors also can enable exchanges to develop competitive proprietary products, making the exchanges more profitable and thereby increasing the value of their equity. These exchanges and their strategic investors are well-funded, sophisticated, and capable to enter the market for proprietary data products.

In a Contestable Market for Proprietary Data Products, a "Fair and Reasonable" Fee Is Best Determined Using the Market-Based Standard Applied by Other Federal Agencies

Section 11A of the Exchange Act, added by the Securities Act Amendments of 1975, requires the exchanges to distribute market data to securities information processors on terms that are "fair and reasonable" and "not unreasonably discriminatory."[2] Congress did not explicitly define what is a "fair and reasonable" or "unreasonably discriminatory" rate, and the Commission should therefore consult the Exchange Act's structure and history, its regulations, and comparable regulatory contexts to give those terms content. Those sources show that the Commission should determine that an exchange's proprietary market-data fee is reasonable so long as the exchange provides a reasoned explanation for imposing the fee and considers statutorily required factors, such as the promotion of efficiency, competition, and capital formation.

When the Commission considers a proposed market data fee, the Exchange Act requires it to consider "whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. § 78c(f). This is not a pro forma requirement. As the D.C. Circuit held when construing identical language in the Investment Company Act of 1940, the Commission has a "statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure." *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005).

A presumption that proprietary market data fees set within that free market are fair and reasonable follows directly from the deregulatory purposes of Regulation NMS and of the 1975 Amendments to the Exchange Act. As discussed more fully above, Regulation NMS and the 1975 Amendments fully support leaving proprietary market data subject to the operation of the free market. And, if the free market should determine whether, proprietary data is sold to broker-dealers at all, it follows that the price at which such data is sold should be set by the market as well. Moreover, permitting regulation, rather than the market, to set the fees charged for proprietary market data would undermine the very free-market efficiencies the Commission hoped the separate selling of proprietary data would create. Although NetCoalition disagrees with the policy choices embodied in Regulation NMS, the Commission concluded that "[t]he time has arrived . . . when decisions must be made and contentious issues must be resolved so that the markets can move forward with certainty concerning their future regulatory environment and appropriately respond to fundamental economic and competitive forces." In the interest of stability and out of respect for the careful deliberative process that led to the adoption of Regulation NMS, the Commission should not upset its policy of allowing market forces to be the primary determinant of the price for proprietary data.

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[2] 15 U.S.C. §§ 78k-1(c)(1)(C), (D).

The regulatory approach taken by other government agencies in similar contexts confirms that a market-based system for pricing proprietary data is "fair and reasonable." For example, the Federal Energy Regulatory Commission routinely employs a market-based standard to determine whether rates are "just and reasonable" under the federal energy laws—language that is nearly identical to the "fair and reasonable" language governing the exchanges' fees for market data. It is FERC's practice to "approve[] applications to sell electric energy at market-based rates . . . if the seller and its affiliates do not have, or adequately have mitigated, market power . . . in the generation and transmission of such energy, and cannot erect other barriers to entry by potential competitors." *La. Energy & Power Auth. v. FERC*, 141 F.3d 364, 365 (D.C. Cir. 1998). This is because "market power is important in determining if customers have genuine alternatives to buying the seller's product." *Louisville Gas and Electric Company*, Docket No. ER92-533-000, 62 FERC P61,016, 61,144 (Jan. 14, 1993).

Thus, for example, in Order 888, FERC allowed electric utility companies to charge market-based rates for wholesale bulk power. *See Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities*, 61 Fed. Reg. 21,540 (May 10, 1996). For existing generation capacity, FERC determines on a case-by-case basis whether a utility lacks, or has adequately mitigated, market power, whereas for new generation capacity, the agency determined to permit utilities to set market-based rates based upon the contestability of the market, rather than a determination regarding market power. *See id*. at 21,542. Utilities may set market prices for new generation capacity without any such showing because, FERC concluded, "in light of the industry and statutory changes that now allow ease of market entry, no wholesale seller of generation has market power in generation from new facilities." *Id*. at 21,549. FERC has also concluded that, in a competitive market, oil pipelines may charge market-based rates. *See, e.g., Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, 58 Fed. Reg. 58,753, 58,754 (Nov. 4, 1993).

Courts have repeatedly sustained FERC's statutory authority to rely on competitive market forces to ensure the reasonableness of fees. In *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866 (D.C. Cir. 1993), for instance, the D.C. Circuit upheld FERC's determination that the Transcontinental Gas Pipeline Corporation ("Transco") could lawfully sell natural gas at the market price negotiated between Transco and its customers. "FERC has made it clear," the court explained, "that it will exercise its . . . authority (upon its own motion or upon that of a complainant) to assure that a market (i.e., negotiated) rate is just and reasonable." *Id*. at 870. "[W]hen there is a competitive market the FERC may rely upon market-based prices in lieu of cost-of-service regulation to assure a 'just and reasonable' result." *Id.* Likewise, *in Louisiana Energy*, 141 F.3d at 365, the D.C. Circuit upheld FERC's practice of using market-based rates where the seller had adequately mitigated its market power. *See also Grand Council of the Crees v. FERC*, 198 F.3d 950, 956 (D.C. Cir. 2000) (stating that it is reasonable for FERC to permit a Canadian energy company to charge market prices where the company lacked market power).

The D.C. Circuit's reasoning in those cases squarely applies to proprietary market data fees. Just as natural-gas rates set in a competitive environment are "just and reasonable," so should the Commission establish a presumption that market data fees set in the competitive environment created by Regulation NMS are "fair and reasonable."

Telecommunications. The Federal Communications Commission has long followed a similar regulatory strategy in determining "just and reasonable" rates within competitive telecommunications markets. In a series of rules and reports dating back to 1979, the FCC has recognized that in competitive markets, "traditional tariff regulation . . . is not only unnecessary to ensure just and reasonable rates, but is actually counterproductive since it can inhibit price competition, service innovation, entry into the market, and the ability of carriers to respond quickly to market trends." *In re Tariff Filing Requirements for Nondominant Common Carriers*, 8 FCC Rcd 6752, 6752 (1993); *vacated on other grounds, Sw. Bell Corp. v. FCC*, 43 F.3d 1515 (D.C. Cir. 1995).

The FCC therefore adopted a regime that broadly deferred to market forces in the setting of "just and reasonable" rates in competitive markets, which became increasingly common in the telecommunications industry in the 1980s and 1990s as technology progressed. Under that regime, "tariff filings of interstate domestic nondominant carriers [were] presumptively lawful," *Id*.. at 6755, and carriers did not need to justify rates with respect to costs. *See Tariff Filings Requirements for Nondominant Common Carriers*, 8 FCC Rcd 1395, 1396 n.19 (1993) (proposed rule). The FCC reasoned that regulation in such markets was unnecessary because competitive market forces themselves would foreclose carriers from charging unjust and unreasonable rates; if they did so, "customers would simply move to other carriers." *Id*. at 1396.

Congress itself recognized in the Telecommunications Act of 1996 that market-based rates in competitive markets are presumptively reasonable. In the Act, Congress provided that the FCC "shall forbear from [requiring rate filing and agency review of] a telecommunications carrier . . . if the Commission determines that . . . enforcement of such regulation . . . is not necessary to ensure that the charges . . . are just and reasonable and are not unjustly or unreasonably discriminatory." 47 U.S.C. § 160(a)(1); *see also id*. § 201(b). In other words, Congress recognized that, where competitive market forces make regulation unnecessary to ensure that rates are reasonable, the FCC should leave the setting of rates to the free market.

Airlines. The presence of vigorous, yet inefficient, nonprice competition among rival airlines impelled Congress to deregulate the airline industry with the Airline Deregulation Act of 1978. While maintaining the requirements that rates be just, reasonable, and non-discriminatory, Congress eliminated filed rates, instead leaving rate-setting to competitive market forces that experience had shown governed the airline industry. *See* Joseph D. Kearney & Thomas W. Merrill, *The Great Transformation of Regulated Industries Law*, 98 Colum. L. Rev. 1323, 1335 (1998). Airline deregulation is thus another instance in which a market-based standard has been used to satisfy a statutory requirement that rates be just and reasonable.

Railroads. The Surface Transportation Board ("STB")—the successor to the Interstate Commerce Commission—may only review railroad rates for "reasonableness" after a threshold determination that there is "an absence of effective competition from other rail carriers or modes of transportation for the transportation to which a rate applies." 49 U.S.C. § 10707(a). For years, the STB has afforded railroads a rebuttable presumption that effective competition exists provided that they make certain evidentiary showings, such as that the complaining shipper can use other railroads and other means of delivery to transport a product between the same two points. *See, e.g., Market Dominance Determinations—Product & Geographic Competition,* STB Ex. Parte No. 627, 1998 WL 887185, at *1-2 (Dec. 10, 1998). Under this analytical test, "a rate level that is constrained by effective competitive alternatives would doubtless be found reasonable." *Id*. at *7.

Under a Market-Based Standard, the Commission Should Defer to the Proposed Fee for Proprietary Data if the Exchange Provides a Reasoned Explanation for Imposing the Fee.

For all of the reasons discussed above, it is appropriate for the Commission to defer to market forces in the setting of proprietary market data fees. That is not to say, however, that review of whether such fees are "fair and reasonable" would be toothless. Instead, the Commission should examine the exchange's justification for imposing the fee to ensure that the exchange has provided a reasoned explanation for the fee and considered the statutorily relevant factors. In other words, just as a court reviewing agency action ensures that the agency has reasonably explained its actions, so too should the Commission ensure that the exchange's explanation for the fee is reasonable.

It is a basic principle of administrative law that, even though a court owes deference to the superior expertise of administrative agencies, a court reviewing administrative action must review the reasonableness of the agency's explanation for the action. The agency's action cannot be "arbitrary and capricious." *See, e.g., Motor Vehicle Mfrs. Assn. v. State Farm Mt. Automobile Ins. Co.*, 463 U.S. 29, 46-57 (1983). Similarly, where a statute administered by an agency is ambiguous, a court defers to the agency's construction if, but only if, the agency has given a reasonable explanation for its construction. *See Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc,* 467 U.S. 837, 842-43 (1984).

Nasdaq suggests that the Commission employ a similar standard in reviewing the reasonableness of proprietary market data fees. Because both of the above standards are based on the value of deferring to the relative expertise of another entity, and because the Commission should defer to the superior economic judgments achieved by a free and competitive market, the Commission should employ a similar approach when reviewing proprietary market data fees—and therefore uphold a proposed proprietary market data fee so long as the exchange provides a reasoned explanation for the fee. Moreover, because that standard reflects well-established principles of administrative law, the

Commission will have a wealth of guidance in the appropriate application of what constitutes a reasoned explanation for a fee.

Factors that would support the exchange's action would include those factors that participants in a competitive market ordinarily and properly consider when setting their prices (and that NYSEArca addressed in its petition). The exchanges could consider, for example, the fees charged for comparably valuable market data products; the extent of the market demand for such products; the need to provide incentives for investment and innovation; and other factors mentioned in the statute, such as the promotion of efficiency, competition, and capital formation.

This market-based standard—which asks whether the exchanges have provided a reasoned explanation for imposing the fee—mirrors the standard the Commission Staff employed in approving the NYSEArca petition, as well as the standard the Commission has employed in reviewing market data fees since 1975. In approving the NYSEArca fee the Commission Staff noted the various factors that NYSEArca had considered in setting the fee for its depth-of-book data, and found that those factors were reasonable. NYSEArca, the Staff explained, had explained that its fees were competitive with—indeed, lower than—comparable products offered by its competitors. Securities Exchange Act Release No. 34-54597 (Oct. 12, 2006). Comparing prices charged by other competitors, of course, is routine, and entirely appropriate, behavior for participants in competitive markets. NYSEArca also noted that it had invested significantly in creating its depth-of-book data, and that such data, as a result of those investments, was of high quality and of significant value to consumers. There is nothing arbitrary about this reasoning, and the Staff was correct to approve NYSEArca's justification as reasonable and consistent with the Exchange Act.

The Division of Market Regulation's approval of the NYSEArca fee, as well as the deferential standard Nasdaq proposes in this letter, are both in keeping with past practice of the Commission, which has long deferred to the reasoning of market participants in the setting of market data fees. Ever since Congress created the national market system in the 1975 Amendments to the Exchange Act, the Commission has substantially relied on information vendors and investors to negotiate reasonable fees among themselves.

In sum, the Commission should hold a data provider's proposed proprietary data fee to be reasonable as long as the exchange or other market participant provides a reasoned analytical basis for the fee and certifies compliance with relevant statutory requirements. *Cf. BellSouth Corp. v. FCC*, 162 F.3d 1215, 1221-22 (D.C. Cir. 1999) (noting that review of agency action is typically deferential and will be upheld as long as the agency provides a "reasoned explanation" for its decision). The exchange's reasoned explanation would include, for example, a brief description of how the rate (1) "protect[s] investors and the public interest," 15 U.S.C. § 78f(b)(5); (2) "will promote efficiency, competition, and capital formation," *id.* § 78c(f); (3) does not "impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title," *id.*

§ 78f(8); and (4) does not discriminate by providing rates on unequal terms to different consumers, *see id.* § 78k-1(c)(1)(D). Any interested party would be free, of course, to respond to these claims by providing the Commission with relevant contrary data during the comment period.

The Commission Should Not Adopt a "Cost-Based" Standard for Review of Fees for Proprietary Data.

By contrast, nothing in the Exchange Act or in sound policy supports the intrusive, "cost-based" standard proposed by NetCoalition for proprietary market data. By substituting regulatory judgments for those of market participants as to what "costs" are appropriate to price into market data fees, such a standard would impair the efficient working of the highly competitive market for proprietary market data and ignore the Commission's carefully drawn distinction in Regulation NMS between consolidated and proprietary market data. That is no doubt why the Commission has declined to adopt "cost-based" ratemaking for market data fees in the past, and why such an approach has been discarded in numerous other regulatory contexts as outmoded and unwise.

Cost-based regulation is inappropriate in a competitive market. The principal goal of cost-based regulation is to attempt to approximate the workings of a competitive market by ensuring that a monopolist—which is not constrained by competitors in the prices it may charge—charges prices that remain reasonably close to the cost of producing the product, and obtains a reasonable rate of return on its capital. *See* Viscusi, Vernon & Harrington, Jr., *Economics of Regulation and Antitrust* 6 (3d ed. 2000). But in a competitive market like the market for proprietary market data, cost-based regulation is superfluous, for competitors and potential new entrants naturally discipline and undercut one another, keeping the price that market participants charge related to the cost of producing the product, and earn the rate of return that the market can efficiently bear. *See, e.g.*, *Tejas Power Corp. v. FERC*, 908 F.2d 998, 1004 (D.C. Cir. 1990) ("In a competitive market . . . it is rational to assume that . . . the price is close to marginal cost, such that the seller makes only a normal return on its investment").

Indeed, by substituting regulatory judgments for market-based ones, cost-based regulation in a competitive environment can distort prices and retard incentives to innovate. That is true because under any cost-based regime, the tools that regulators use to mimic a competitive market will inevitably be imperfect and create perverse incentives for regulated entities to exploit the ratemaking formula to their own private advantage. For example, under cost-of-service ratemaking, a regulated entity's capital investments often contribute to the rate base whether or not such investments are efficient. *See* Herbert Hovenkamp, *Antitrust and the Regulatory Enterprise*, 2004 Colum. Bus. L. Rev. 335, 361-62. Cost-of-service ratemaking thus encourages companies continually to expand their infrastructure (such as by constructing new production plants), even if the market price for the additional output does not justify the investment. *See id.*

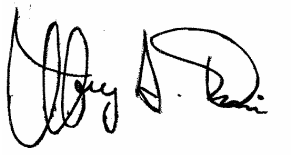
Similarly, cost-based ratemaking can discourage innovation because it blunts incentives for companies to cut costs. In a free market, increased efficiency in production

leads to additional profit. By contrast, in a rate-based regime, lower costs lead to a lower rate base, which in turn can lead to a reduced rate of return. *See id.* As the FCC has noted, in a competitive market, "a company's costs and profits generally are inversely related. If one goes up, the other goes down. Rate-of-return regulation stands this relationship on its head." *See In the Matter of Policy and Rules Concerning Rates for Dominant Carriers*, Release No. 88-172, 3 FCC Rcd 3195, 3205 (May 12, 1998). It is difficult for regulators to counteract those perverse incentives because they are poorly placed to second-guess a company's judgment about the investment needed to provide a service, or about the proper allocation of costs among multiple interrelated services. *See id.* at 3205-06.

Conclusion

In sum, the Commission should find that fees for proprietary market data—which is bought and sold in a fiercely competitive market—are reasonable as long as the exchanges provide a rational explanation for the fee. That standard is consistent with the text, history, and purposes of the Exchange Act, nearly 30 years of established agency precedent under the Amendments, and the approach that the Commission adopted in Regulation NMS. This approach, not cost-based regulation, ratifies the basic policy choices underlying the Act and agency precedent: that rates for proprietary market data fees should be the product of competitive market forces, rather than regulatory requirements.

Respectfully submitted,



Vice President and
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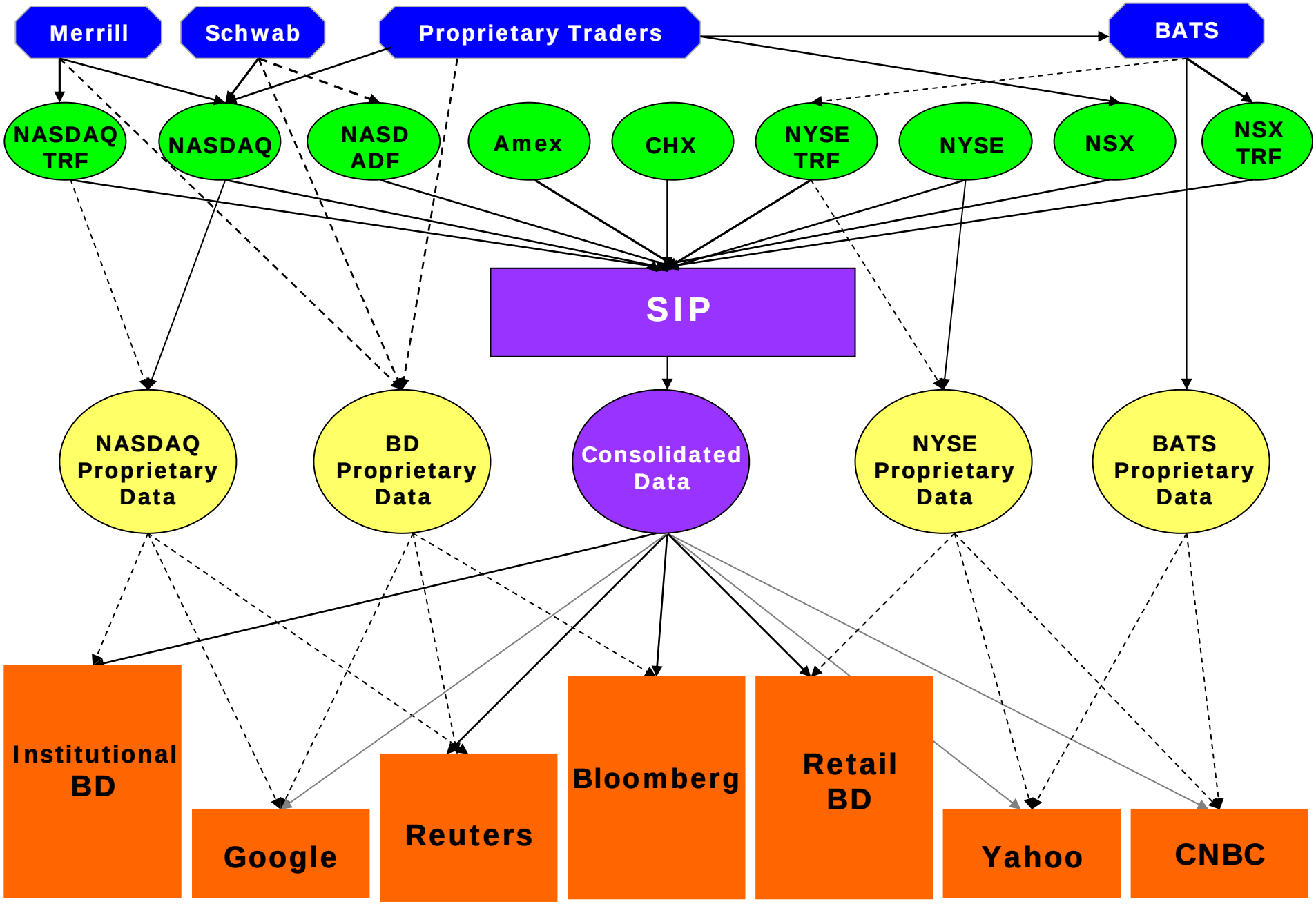
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