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Regulation NMS; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 200, 230, 240, 242, and 249

[Release No. 34–49749; File No. S7–10–04]

RIN 3235–AJ18

Regulation NMS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule; extension of comment period and supplemental request for comment.

SUMMARY: The Securities and Exchange Commission (''Commission'') is extending the comment period on rules proposed under Regulation NMS, which were published in Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126 (March 9, 2004) (''Proposing Release''). The original comment period would have expired on May 24, 2004. The new comment period will expire on June 30, 2004. In addition, the Commission is supplementing its request for comment on the proposed rules to reflect the hearing on Regulation NMS that was held on April 21, 2004 (''NMS Hearing''). During the NMS Hearing, panelists discussed developments that bear on many significant issues raised by the proposed rules. The Commission is publishing this supplemental request for comment and extending the comment period to assure that the public has a full opportunity to address such issues in their comments.

DATES: Comments should be received on or before June 30, 2004.

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

Electronic comments:

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

Paper comments:

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

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

FOR FURTHER INFORMATION CONTACT: Daniel M. Gray, Attorney Fellow, at (202) 942–0159, or Heather Seidel, Attorney Fellow, at (202) 942–0788, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001.

SUPPLEMENTARY INFORMATION:

I. Introduction

The Proposing Release published Regulation NMS for public comment. In addition to redesignating the existing national market system (''NMS'') rules adopted under Section 11A of the Securities Exchange Act of 1934 (''Exchange Act''), Regulation NMS incorporated four substantive proposals that are designed to enhance and modernize the regulatory structure of the U.S. equity markets. First, the Commission proposed a uniform rule for all NMS market centers that, subject to two significant exceptions, would require a market center to establish, maintain, and enforce policies and procedures reasonably designed to prevent ''trade-throughs''—the execution of an order in its market at a price that is inferior to a price displayed in another market (''Trade-Through Proposal''). Second, the Commission proposed a rule that would modernize the terms of access to quotations and execution of orders in the NMS (''Access Proposal''). The third proposal would prohibit market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment finer than a penny, except for securities with a share price of below $1.00 (''Sub-Penny Quoting Proposal''). Finally, the Commission proposed amendments to the rules and joint industry plans for disseminating market information to the public that, among other things, would modify the formulas for allocating plan revenues to reward markets for more broadly based contributions to public price discovery (''Market Data Proposal'').

On April 21, 2004, the Commission held the NMS Hearing in New York City.[1] The NMS Hearing was composed of a series of seven panels that collectively addressed each of the four proposals. The panelists included a wide range of market participants who discussed the proposals themselves, as well as their own initiatives intended, at least in part, to respond to the proposals. The Commission is extending the comment period and publishing this supplemental request for comment to give the public a fuller opportunity to reflect the NMS Hearing in their comments on the proposals.[2]

A significant element of the NMS Hearing was the intention expressed by various representatives of exchanges with traditional trading floors to establish facilities in the coming months that will offer automatic execution of orders seeking to interact with their displayed quotations (''Auto-Ex Facilities'').[3] Panelists also emphasized that the essential element of an effective Auto-Ex Facility is an immediate automated response (*i.e.*, one without any manual intervention) to the router of the incoming order.[4] They stated that the response must be either that the order was executed (in full or in part) or that it could not be executed (because, for example, a prior incoming order already had executed against the displayed quotation). The exchange representatives acknowledged the challenges posed by developing an efficient hybrid market—one that integrates an active trading floor with an Auto-Ex Facility. They emphasized, however, that they were well advanced in their efforts and indicated that such facilities are likely to become operational within a time frame that could precede any potential implementation date for Regulation NMS, should the Commission decide to adopt the proposals.[5]

In addition, panelists at the NMS Hearing noted that existing order routing technologies were capable of identifying, on a quote-by-quote basis, indications from a market center that a particular quotation was not accessible

[1] A full transcript of the NMS Hearing (''Hearing Tr.''), as well as an archived video and audio webcast, is available on the Commission's Internet Web site (*http://www.sec.gov*).

[2] The discussion in this supplemental request for comment assumes familiarity with the Proposing Release and therefore does not restate all of the specific terms of the proposals. In addition, the Commission continues to request comment on all of the matters set forth in the Proposing Release.

[3] Hearing Tr. at 85, 90–92, 94–97, 120.

[4] Hearing Tr. at 32, 55–56, 65–66, 158.

[5] For each of the four substantive proposals under Regulation NMS, the Proposing Release requested comment on the appropriate phase-in period that would be needed to allow participants time to adapt to the proposed new regulatory environment.

through an Auto-Ex Facility.[6] The ability to display such a quotation potentially would give exchanges with trading floors the flexibility to integrate effectively the trading floor with an Auto-Ex Facility. Rather than being classified as ''fast'' or ''slow,'' markets would be allowed to offer choices to investors. In those particular contexts when a market's quotation was not accessible through an Auto-Ex Facility (for example, to provide an opportunity for the floor to generate additional price discovery or price improvement), the quotation would be identified as such and order-routers could respond accordingly. As discussed further below, the Regulation NMS proposals also could be drafted to reflect whether a quotation was, or was not, accessible through an Auto-Ex Facility. Competitive forces and the needs of investors, rather than regulatory classifications, would determine the relative success of various types of manual and automated trading facilities.

The near-term prospect that quotations displayed in the NMS may be predominantly accessible through Auto-Ex Facilities, but with some flexibility for markets to offer investors the choice of manual trading, potentially has very significant consequences for the rules proposed under Regulation NMS. Some of the most difficult issues raised by the proposals, particularly those relating to trade-throughs, access, and market data, derive from the problem of accommodating both auto-executable and manual quotations within the NMS. These problems could largely disappear in the near future if NMS quotes become predominately accessible through Auto-Ex Facilities. One of the primary purposes of the supplemental request for comment that follows is to encourage the public to address the opportunities that such a development would offer for making substantial progress toward a more efficient NMS for investors.

II. Trade-Through Proposal

A. Exception for Manual Quotes

The Proposing Release recognized that there are differences between the speed and certainty of response in electronic (*i.e.* automated) versus manual (*i.e.* non-automated) markets. To provide flexibility to market centers with different market structures, the Commission proposed an exception to the trade-through rule to allow an automated market to trade-through a non-automated market up to a certain amount.[7] Many panelists at the NMS Hearing agreed that the distinction between an automated and non-automated market—a market that provides immediate access to its quotes through automatic execution and one that does not—is important, and that market participants should be able to trade-through a manual market.[8] Panelists at the NMS Hearing, however, expressed the view that the distinction could, and perhaps should, be made between manual and automated quotes, rather than manual and automated markets.[9]

The Commission therefore requests further comment on the operation of the proposed exception for manual markets. Specifically, the Commission requests comment as to whether the exception from the proposed trade-through rule should apply to quotes that are not immediately accessible through an Auto-Ex Facility (a manual or non-automated quote), rather than providing an overall exception for a manual market.[10] Would narrowing the scope of the proposed exception to manual quotes allow market centers and broker-dealers to more efficiently execute orders across markets, while at the same time preserving the protections of a trade-through rule? By not forcing a market center into a rigid classification—automated or manual, would providing an exception for manual quotes, on a quote-by-quote basis, provide more flexibility for market centers with different market structures to compete more fairly with each other? For instance, would narrowing the exception to manual quotes, which would allow a market center with an Auto-Ex Facility to display a manual quote in particular limited circumstances, provide more flexibility for a market center with a floor-based structure to effectively integrate its trading floor with an Auto-Ex Facility, if it so desired?[11] Would a quote-by-quote exception allow markets more flexibility to provide investors a choice as to a manual or automatic execution? Comment also is requested on whether a quote-by-quote exception would create difficulties for routing systems that could not be easily managed.

The Commission requests comment as to the best way to effectuate a quote-by-quote exception to the proposed trade-through rule for manual quotes. Panelists at the NMS Hearing stated that it would be possible to attach an identifier to manual quotes in the consolidated quote stream so that all market participants would know the quote was a manual quote.[12] The Commission requests comment on the feasibility of this approach, and how it would work in practice. Should the Commission explicitly require each market center, as part of its required policies and procedures,[13] to implement a process to identify any non-automated bid or offer that it posts in the consolidated quote stream as manual? Should the Commission require that the NMS plans that govern the collection, consolidation and dissemination of quotes in NYSE, Amex and Nasdaq-listed stocks be amended to provide for this functionality with regard to the quotes sent to the processors for those plans?[14] Should each self-regulatory organization (''SRO'') be required, as part of its policies and procedures for complying with the proposed trade-through rule, to impose a requirement on its members that they identify their bids and offers as manual when submitting them to the SRO?

Comment also is requested on whether a market center should be able to decide on a security-by-security basis whether its quotes will be automated or manual. The Commission recognizes that an exception for manual quotes, as outlined above, would necessarily provide market centers with this (and more) flexibility, by allowing them to identify all quotes in a particular security as manual quotes. If the Commission adopted an exception to the trade-through rule for manual markets rather than manual quotes, however, should the exception explicitly allow a market to choose to be

[6] Hearing Tr. at 57, 142–144, 157–158.

[7] The Commission requested comment on all aspects of this proposed exception, including in particular how to define an automated market, and by what amount a market should be allowed to trade-through a manual market. *See* Section III.D.2 of the Proposing Release.

[8] *See, e.g.*, Hearing Tr. at 56–57, 63–67, 72, 75–76, 86, 132, 136, 142, 158. One panelist characterized the distinction as between ''maybe'' and executable firm quotes. See Hearing Tr. at 52–53, 55–57.

[9] Hearing Tr. at 57–58, 142–144, 157–158.

[10] In Section III.B of this Release, the Commission requests further comment on whether or not there should be trade-through protection for ''high-fee'' quotes. *See also* Section III.F of the Proposing Release that requested comment on this issue as well.

[11] *See* Hearing Tr. at 57 (panelist expressing the view that focusing on automated quotes would provide market centers with flexibility to evolve towards a more automated system in any way they see fit).

[12] Hearing Tr. at 57, 142, 157–158.

[13] *See* Section III.C.5 of the Proposing Release for a discussion of the required policies and procedures that each order execution facility would be required to establish, maintain and enforce pursuant to the proposed trade-through rule, proposed Rule 611 of Regulation NMS.

[14] The NMS plans are described in Sections III.B.1 and VI.A of the Proposing Release.

automated or manual on a security-by-security basis?

1. Definition of an ''Automated'' Quote

Several panelists at the NMS Hearing expressed the view that the concept of an ''automated'' market or quote must encompass an immediate automated response to the order router as to what action was taken with respect to the order.[15] In other words, certainty as to whether an order seeking to interact with a displayed quote can immediately interact with such quote—knowing instantaneously whether an order was executed (in full or in part) or cancelled—is key.

In the Proposing Release, the Commission proposed to define an ''automated order execution facility'' as a order execution facility that provides for an immediate automated response to all incoming orders for up to the full size of its best bid and offer disseminated pursuant to an effective national market system plan, without any restrictions on executions.[16] The Commission requests comment on whether it should make explicit in the proposed definition of an automated market or automated quote that providing an immediate automated response would include immediately sending a report back to the market center that submitted the order, either reporting an execution or cancellation. In addition, should the Commission make explicit that the automated market or quote must provide an automatic execution functionality for the whole order or provide an automatic cancellation for the remaining portion of an order not executed against the quote?

The Commission also requested comment in the Proposing Release as to whether it should provide specific guidance with regard to what ''immediate'' would mean in terms of providing an automated response.[17] Panelists believed that, at a minimum, for a quote to be considered automated there must be no manual or human intervention involved in responding to an order seeking to interact with that quote.[18] In the Proposing Release, the Commission requested comment as to whether it would be appropriate to impose a performance standard with respect to response times.[19] The Commission notes that panelists at the NMS Hearing advocated imposing a maximum response time, such as one second or a quarter of a second.[20]

The Commission requests further comment on whether it should impose performance standards, such as no less than one second, or a quarter of a second, or some other time frame, on the total time for a market center to respond to an order in an automated manner, *i.e.*, the time from when the order is received by the executing market center to the time that the executing market center sends a report back to the order router indicating the action taken with respect to the order. Would imposing a performance standard alleviate concern that, because each market otherwise would be able to determine what ''immediate'' means with respect to its own bids and offers, a market participant might be required to access a better price on a market center that it did not believe provided an immediate response? Would market centers continue to have an incentive to compete on the basis of execution speed if a performance standard were imposed?[21] The Commission also requests comment on whether there is a need to impose a response time of less than one second. Specifically, would investors benefit significantly, or at all, from sub-second response times? If so, how would they benefit? Additionally, would it be necessary or advisable to impose sub-second response times in order to promote a smoothly operating marketplace?

The Commission requests comment with regard to surveiling for and enforcing compliance with a performance standard. In particular, the Commission requests comment on whether, if it were to adopt a performance standard, it should require that each market center publicly disclose the percentage of time, or each actual instance, that it did not provide a response in compliance with the standards required by the rule. Would requiring public disclosure provide an added incentive for market centers to continue to improve their technology and the services they provide? Would it allow market participants and the Commission to better determine if the quotes of a market center that the market center determine to be automated are indeed automated in compliance with the proposed standards? Is there any other mechanism by which market participants could determine whether market centers were providing an immediate automated response in compliance with any performance standards imposed?

One panelist at the NMS Hearing expressed the view that a market center posting a bid or offer should be required to automatically update that quote, in order to be deemed an automated market.[22] The Commission agrees that providing an automatic update to the best bid or offer is important because market participants other than the participant whose order executed against the quote need to know whether a particular quote is still available or not. Not updating a quote to immediately reflect the true status of the quote inhibits full transparency and could lead to uncertainty as to whether the market center's quotes are indeed immediately accessible through an Auto-Ex Facility. The Commission therefore requests comment on whether, in order for a market center or quote to be considered automated, the market center posting the quote should be required to provide for an automated update to the quote it is executed against. The Commission also requests comment on whether it should impose a performance standard, such as one second, on the time within which the order execution facility would be required to update its automated quote. Finally, comment is requested on whether the Commission should require market centers to provide an automatic cancellation functionality that would allow a market participant that has put a limit order on the market center's limit order book to automatically cancel the limit order. If so, should the Commission require that cancellations be honored within a certain time frame, such as less than one second?

2. Allowable Trade-Through Amount

In the Proposing Release, the Commission requested comment on the amount by which a market should be allowed to trade through a manual market.[23] Panelists at the NMS Hearing expressed the view that a market center should be allowed to trade-through a manual market by an unlimited amount.[24] One panelist stated that the ability to trade-through a manual market has to be ''unfettered'' because of a concern with the practicality of complying with the proposed tiered approach (which would look to the NBBO of the security at the time of execution for purposes of determining the allowable trade-through amount)

[15] *See, e.g.*, Hearing Tr. at 54–57, 65–66, 133, 158.

[16] *See* Section III.D.2.a of the Proposing Release and paragraph (b)(3) of proposed Rule 600 of Regulation NMS. The Commission requested detailed comment on this proposed definition. See Section III.D.2 of the Proposing Release.

[17] *See* Section III.D.2.a of the Proposing Release.

[18] *See* Hearing Tr. at 29, 32, 55–56, 59.

[19] *See* Section III.D.2.a of the Proposing Release.

[20] *See* Hearing Tr. 59 and 86 (advocating a ¼ of a second, at least 98% of the time), 62 (advocating that a fast market is under one second).

[21] *See* Hearing Tr. at 25–28.

[22] Hearing Tr. at 14.

[23] *See* Section III.D.2.c of the Proposing Release.

[24] Hearing Tr. at 57–58, 67.

given the incidence of flickering prices in today's market.[25] The Commission requests further comment as to the amount by which a market should be allowed to trade through a manual quote. Specifically, the Commission requests comment as to whether there should be no limit. As emphasized in the Proposing Release, however, such an exception to the trade-through rule would in no way alter or lessen a broker-dealer's duty to achieve best execution.[26]

B. Opt-Out Exception

Panelists were split about the need for an opt-out exception. Some panelists at the NMS Hearing expressed the view that there would be no need, or valid policy reason, to allow a market to trade through an automated market or automated quote of another market.[27] In addition, representatives of two floor-based exchanges have publicly expressed the intent to take the necessary steps to become automated for purposes of the proposed exception to the trade-through rule.[28] Thus, the Commission requests comment as to whether, if it were to adopt an exception to the trade-through rule for manual quotes, the proposed opt-out exception would still be necessary or desirable.

Other panelists supported an opt-out exception.[29] Several panelists at the NMS Hearing stated that one benefit of the proposed opt-out exception is that it could create market pressure that would discipline markets that provided slow executions or inadequate access to their markets.[30] The Commission requests comment on this issue. Would there be less of a need for the opt-out as a mechanism for market discipline if the Commission were to adopt explicit performance standards with regard to defining what an ''immediate'' automated response means under an exception for manual quotes?

If commenters believe that an additional mechanism is needed to exert market pressure on market centers, what type of mechanism would be effective but still support the underlying goals of price protection and best execution? For instance, as discussed above in Section II.A.1, whether or not the Commission adopted a performance standard with regard to an exception for a manual market or quote, should the Commission require each market center to publicly disclose how often it provided an immediate automated response within certain time frames or within the performance standards?

Another potential use of the opt-out exception could be to by-pass quotations likely to be unavailable due to prior execution. Such a use could arise, for example, when a quotation suddenly becomes attractive to many traders at the same time (*e.g.*, because of a price change in a related security). One can conceive of circumstances in which a large, and perhaps rapidly growing, number of orders pursues a small and rapidly changing number of quotations. The Commission would be concerned if such scenarios could severely impact individual market centers or even interfere with the smooth functioning of the marketplace. The Commission requests comment on whether such scenarios are likely, what their potential impact might be, and whether a specific exception to the trade-through rule is needed to provide market participants with acceptable means to execute their orders under such conditions. If commenters believe an exception is needed, the Commission requests information on the nature of the requirement and the form that such an exception might take. The Commission requests comment on whether an opt-out exception would be needed for customers of order execution facilities that do not currently interact with other exchanges or order execution facilities.

C. Other Exceptions

The Commission also is requesting further comment as to whether there are particular types of transactions the execution of which should be excepted from the proposed trade-through rule that are not covered by the proposed exceptions, consistent with the fundamental policies of price priority.[31] For example, should there be an exception provided for basket or program trades that are executed at a single price distinct from current prices for each of the securities contained in the basket? In addition, should an exception be provided for an ''intermarket sweep order'' by which a market participant can simultaneously route orders to interact with all best bids and offers displayed in the consolidated quote system?[32] As proposed, paragraph (b)(7) of Rule 611 of Regulation NMS would provide an exception for those instances where an order execution facility sends an order to execute against a better-priced order displayed on another market at the same time or prior to executing an order in its own market at an inferior price.[33] The Commission recognizes, however, that a market center that receives one part of an ''intermarket sweep order'' would not know that other ''sweep'' order(s) have been sent to other market centers to attempt to execute against any better-priced bids or offers displayed on those markets, unless the order(s) were identified in some manner. Thus, the receiving market could, pursuant to the proposed trade-through rule, route the order it received to another market displaying a better price, even though the order router already has attempted to take out those better prices. Therefore, the Commission is requesting comment as to how each order sent by a market participant in compliance with a ''sweep order'' exception should be identified so that the receiving market center would be able to execute the order without regard to whether a better price were displayed on another market center.

D. Type of Securities Subject to the Proposed Rule

Some panelists at the NMS Hearing questioned the need for a trade-through rule and argued against extending the trade-through rule to the Nasdaq market. Given the prospect of greater automation of execution facilities discussed at the NMS Hearing, the Commission requests comment on how such a development would affect the need for a trade-through rule in the market for listed securities. In this connection, the Commission also reiterates its request for comment on the need to expand the trade-through rule to the Nasdaq market.

III. Access Proposal

The Access Proposal includes three primary parts: standards for market access, limitations on access fees, and standards to address locked or crossed quotations. An overview of the Access Proposal is set forth below to promote greater understanding of its details and to assist commenters in formulating their views. Next, additional comment is requested on the potential alternatives

[25] Hearing Tr. at 67. *See* Section III.D.2.c of the Proposing Release for a detailed description of the proposed allowable trade-through amounts.

[26] Section III.C.7 of the Proposing Release.

[27] Hearing Tr. at 32, 58, 65, 74, 80, 84, 85, 154.

[28] Hearing Tr. at 85, 88, 90–92, 94–95, 97, 116.

[29] Hearing Tr. at 14–15, 18, 19, 36.

[30] Hearing Tr. at 28, 35–36, 43.

[31] *See* Section III.D of the Proposing Release for a discussion of the proposed exceptions to the trade-through rule.

[32] An ''intermarket sweep order'' could arise where a market center wants to be able to route an order(s) to execute against any better-priced bid(s) or offer(s) on other market center(s) at the same time as or prior to executing the remaining balance in its own market at an inferior price, or a market participant could wish to execute the entirety of an order it holds by sending orders to interact with the best bids and offers displayed on other market centers. *See* Hearing Tr. at 53–54, 145–146.

[33] *See* Section III.D.3 and note 82 of the Proposing Release.

for other aspects of Regulation NMS if access fees are not limited to a *de minimis* amount.

A. Overview of Access Proposal

1. Market Access Standards

Paragraph (a) of proposed Rule 610 under Regulation NMS would establish access standards for two types of market centers, which between the two would encompass all quotations that are disseminated to the public through the consolidated data stream. First, an SRO order execution facility (defined in proposed Rule 600(b)(61) as a ''quoting market center'') would be prohibited from imposing unfairly discriminatory terms that inhibit a non-member, non-customer, or non-subscriber from obtaining access to quotations and the execution of orders through a member, customer, or subscriber.[34] Second, any broker-dealer whose quotations are *not* available for execution through any SRO order execution facility (such a broker-dealer would be defined in proposed Rule 600(b)(62) as a ''quoting market participant'' (''QMP'')) [35] also would be prohibited from imposing unfairly discriminatory terms that inhibited a non-member, non-customer, or non-subscriber from obtaining access to quotations or the execution of orders through a member, customer, or subscriber. This standard is intended to assure that all parties have effective indirect access through members and subscribers to quotations displayed by SRO order execution facilities and QMPs, thereby obviating the necessity for direct, intermarket linkages between market centers such as the Intermarket Trading System (''ITS'').

In addition, the Access Proposal would address *direct* access to markets in two contexts. First, paragraph (a)(2)(i) of proposed Rule 610 would require a QMP to provide access to its quotations to allow SRO order execution facilities and other QMPs to route orders for execution to the QMP on terms as favorable as those that the QMP grants to its most preferred member, customer, or subscriber. This additional requirement is necessary because a QMP's quotes would not, by definition, be otherwise available for execution through any SRO order execution facility. Second, the trading threshold that triggers the fair access standards of Rule 301(b)(5) of Regulation ATS would be lowered from 20% to 5% of the average daily volume in a security.[36] When subject to such fair access standards, an ATS is prohibited from unreasonably limiting any person from obtaining access to the ATS's services, such as by becoming a direct subscriber of the ATS.[37]

The Commission continues to request comment on all of the issues relating to standards of direct and indirect access that were raised in the Proposing Release. In addition, panelists at the NMS Hearing indicated that access could remain a problem at relatively inactive ATSs or market makers with little trading volume whose quotations were displayed only in the ADF (and therefore fell within the proposed definition of a QMP).[38] Market participants could obtain access to such quotations only through direct connections with the particular ATS or market maker. Panelists suggested that such an entity should be required to publish its quotations in an SRO order execution facility, at least until its share of trading reached a point where the cost of direct connections with multiple market participants would not be out of proportion to the entity's level of trading. Comment is requested on this issue. Alternatively, SROs without an order execution facility could be required to ensure that any potential QMP is directly connected to most market participants, before publishing that QMP's quotations. Finally, comment is requested in general on whether market participants currently have effective and efficient access to SRO order execution facilities and QMPs and whether this access provides a sound basis for the proposed regulatory approach.

2. Limitations on Access Fees

Paragraph (b) of proposed Rule 610 would establish a *de minimis* standard for access fees. The fee limitation with the broadest scope is set forth in proposed paragraph (b)(4), which would limit to no more than $0.002 per share in any transaction the accumulated access fees that could be charged by any SRO order execution facility, QMP, or other broker-dealer to any person, including subscribers, members, or other market centers.[39] This *de minimis* standard is designed to promote a common quoting convention and to facilitate the ready comparison of quotations across the NMS.

Application of the proposed fee limitations to different types of entities would vary depending on how a quotation were accessed by an order router. Such access could be divided into three categories.

First, quotations could be accessed through an SRO order execution facility. Under paragraph (b)(1) of proposed Rule 610, the SRO order execution facility would be authorized to charge a fee of no more than $0.001 per share. In addition, if the quote were attributable to a particular broker-dealer, the broker-dealer also would be authorized to charge a fee of no more than $0.001 per share under paragraph (b)(3) of proposed Rule 610. The purpose of the ''attributable'' requirement is to enable an order router to know in advance whether an additional broker-dealer fee would be charged when a quotation is accessed through an SRO order execution facility.[40] The quotation therefore would not need to be explicitly attributed to a broker-dealer individually in the consolidated data stream. Instead, the ''attributable'' requirement would be satisfied if an SRO effectively and publicly identified the broker-dealer responsible for a quotation. For example, a quotation would be attributable if the SRO identified a single specialist responsible for all quotations in a given security, or

[34] The phrase ''access to quotations and execution of orders'' would encompass access both to a market's best bid and offer and to quotations included in a market's ''depth of book.''

[35] Currently, the only broker-dealers that would fall within the proposed definition of a QMP are ATSs or market makers whose quotations are displayed in the consolidated data stream solely through the Alternative Display Facility (''ADF'') operated by the NASD. If a broker-dealer makes its quotations available for execution through any SRO order execution facility, it would not fall within the proposed definition of a QMP.

[36] 17 CFR 242.301(b)(5).

[37] The fair access standards of paragraph (b)(5) of Rule 301 of Regulation ATS do not require ATSs to provide indirect access to non-subscribers to such services as displaying limit orders, use of special handling orders, or proprietary market data. Paragraph (b)(3) of Rule 301 addresses the ''execution access'' required to an ATS's best bid and offer that is provided to an SRO for inclusion in the consolidated data stream. It requires an ATS to provide execution access that is equivalent to the access provided to other quotations displayed through such SRO.

[38] Hearing Tr. at 135, 138–139.

[39] The term ''access fee'' as used in proposed Rule 610 would include any fee charged by an SRO order execution facility, QMP, or broker-dealer that is based on the execution of orders against its displayed quotations. It therefore encompasses both the specific fees charged by ATSs to non-subscribers for access to their quotations, as well as any other fees charged by SROs and ATSs to their members and subscribers that are based on the execution of orders against their displayed quotations. Comment is requested on the definition of access fees. Should it be broadened to include order cancellation fees, fees for capacity usage, or any fee charged by the market center specific to a transaction?

[40] Comment is requested on whether this policy objective to give advance notice could be achieved with respect to non-attributable quotes (for example, if the SRO specified the fee that could be charged by broker-dealers who displayed non-attributable quotes through the SRO's order execution facility). Comment also is requested on alternatives other than an attribution requirement for achieving the objective of notifying order-routers that an additional broker-dealer fee would be charged for accessing a quotation through an SRO order execution facility.

if the SRO disseminated a proprietary public data stream identifying the broker-dealer responsible for a particular quotation.

Second, quotations could be accessed through a QMP (*i.e.*, an ATS or market maker whose quotes were displayed in the ADF and were not accessible through any SRO order execution facility). This type of entity would be authorized to charge a fee of no more than $0.001 per share.

Third, quotes could be accessed directly through a broker-dealer who was not a QMP because its quotes also were accessible through an SRO order execution facility. Except for the accumulated fee limitation of $0.002 per share set forth in paragraph (b)(4) of proposed Rule 610, this type of direct access to a non-QMP broker-dealer's quotes is not specifically covered by the proposal. Consequently, the fees for this type of access to quotations would continue to be governed by existing rules, which vary depending on whether the broker-dealer is an ATS or a market maker.

Under this third type of access, ATSs, which are subject to the access standards of Regulation ATS, would continue to be allowed to charge a fee for access to their quotations, subject to the accumulated fee limitation of $0.002 per share. Although ATSs would not be explicitly limited to a fee of $0.001, as are SRO order execution facilities, competitive factors likely would preclude ATSs from being able to retain more than $0.001 of the maximum $0.002 fee. Broker-dealers with displayable orders would know that they could submit such orders directly to an SRO order execution facility and charge a fee of $0.001.[41] Consequently, they would be unlikely to submit their orders to an ATS if the ATS does not agree to pay a rebate of at least $0.001 to match what the broker-dealer could obtain through an SRO order execution facility. If the ATS charged the maximum $0.002 fee, this would leave the ATS with only $0.001 after the rebate to the broker-dealer—the same fee that an SRO order execution facility would be authorized to charge under paragraph (b)(1) of proposed Rule 610.

In contrast to ATSs, market makers currently are not permitted to charge a fee for access to their quotes under Exchange Act Rule 11Ac1–1(c)(2) (the ''Quote Rule'') (proposed to be redesignated as Rule 602 under Regulation NMS). If adopted, Rule 610(b)(3) would affirmatively authorize a market maker to charge a fee of no more than $0.001 per share only in the specific context of when an attributable quote were accessed through an SRO order execution facility. Outside of this context, however, existing rules would continue to apply and market makers would not be authorized to charge a fee for direct access to their quotes. Unlike ATSs, market makers are not subject to the additional access requirements imposed by Regulation ATS.

For each of the fee limitations in proposed Rule 610(b), the scope of quotations covered by the limitation should be interpreted in conjunction with the definitions in proposed Rule 600(b)(61) and (62) of a ''quoting market center'' and a ''quoting market participant.'' The definitions would encompass, respectively, an SRO order execution facility that made its best bid and offer available pursuant to the Quote Rule, and a broker-dealer that provided its best bid and offer to an SRO pursuant the Quote Rule or Regulation ATS. The scope of the fee limitations in proposed Rule 610(b) would be limited to these best bids and offers, all of which are disseminated to the public through the consolidated data stream. Such bids and offers would be eligible for trade-through protection under the proposed trade-through rule. These bids and offers also are eligible to be designated as national best bids and offers (''NBBOs) and therefore could have significant implications for purposes of a broker-dealer's duty of best execution. The proposed fee limitations would help assure that all order routers had efficient access to the quotations necessary to fulfill their regulatory responsibilities. The fee limitations would not, however, cover quotations included in a market's depth of book. Accessing depth of book is more subject to the choice of order routers than accessing best bids and offers. Also, order routers can avoid interacting with a market's depth of book by submitting an order with a limit price at the best bid or offer.[42]

Comment is requested on the structure of the various fee limitations set forth in proposed Rule 610(b). Comment also is requested on whether the Commission should simply adopt a single accumulated fee limitation, such as the one set forth in paragraph (b)(4) that would apply to all types of market centers. If a single accumulated fee limitation were adopted, would $0.002 per share be an appropriate amount, or should it be higher or lower? Comment also is requested on whether fee limitations should apply to undisplayed orders at prices better than the best displayed quote, reserve size at the displayed quote, or quotes displayed or available at prices inferior to the displayed quote. Are these limitations needed to avoid discouraging the display of quotes? Further, would limiting access fees discourage the display of quotes?

3. Locked or Crossed Quotations

Paragraph (c) of proposed Rule 610 sets forth standards addressing locked or crossed quotations. It would require every SRO to establish and enforce rules that require its members to avoid locking or crossing quotations, that are reasonably designed to enable market participants to reconcile locked or crossed quotations, and that prohibit its members from engaging in a pattern or practice of locking or crossing quotations.

As discussed above, panelists at the NMS Hearing suggested that quotations not accessible through an Auto-Ex Facility should be identified as such in the consolidated data stream. Comment is requested on whether market participants submitting quotations that *are* automatically executable should be allowed to lock or cross quotations that are identified as *not* being automatically executable.[43]

B. Alternatives to Access Fee Limitations

The Proposing Release requested comment on how other aspects of proposed Regulation NMS would be affected if the Commission ultimately determined not to limit access fees to a *de minimis* amount. In the discussion of the Trade-Through Proposal, for example, comment was requested on whether, if fees were not limited, quotations with fees of greater than a *de minimis* amount should be excluded from protection under the proposed trade-through rule.[44] In addition, the discussion of the Market Data Proposal noted the close connection between the

[41] If, however, the broker-dealer with a displayable order wished to retain anonymity, it could not charge a fee for an execution through an SRO order execution facility because the quote would not be attributable. In contrast, the broker-dealer could retain its anonymity by placing the order with an ATS. Comment is requested in note 42 above on possible alternatives to the attribution requirement, which could eliminate the difference in treatment between access to quotations through SRO order execution facilities and direct access through ATSs.

[42] The fee limitations would apply to any order execution at the displayed price of the best bid or offer. They therefore would encompass executions against both the displayed size and the reserve size of a quotation.

[43] As discussed below, the Commission also is requesting comment on the issue of whether, if the proposed fee limitations are not adopted, markets with *de minimis* fees should be allowed to display quotations that lock quotations with high fees.

[44] Section III.F of the Proposing Release.

issue of limiting access fees and allocating market data revenues based on a market's quotations. Comment was requested on whether, if fees were not limited, quotations with greater than *de minimis* fees should be excluded from an allocation of market data revenues.[45]

The Commission renews its request for comment on whether it should or should not adopt any access fee limitation and, if it does not adopt a fee limitation, on alternative measures that potentially could be adopted. In particular, should quotations with high fees be treated differently than quotations with *de minimis* fees for purposes of the other proposals? The differing treatment could reflect the fact that, for example, a $10.00 quotation with a high fee is not equal to $10.00 quotation with a *de minimis* fee. Quotations with fees of more than a *de minimis* amount could be identified as such in the consolidated data stream, analogous to the identification of quotations not accessible through an Auto-Ex Facility that was discussed above. Such high-fee quotations could be excluded from protection under the trade-through rule, eliminated from the allocation of market data revenues, and subject to locking quotations from market centers with *de minimis* fees.[46] Comment is requested on the advisability of these alternatives, as compared with adopting a limitation on access fees.

IV. Market Data Proposal

At the NMS Hearing, the market data panelists focused primarily on two issues—the level of market data fees and the complexity of the proposed formula for allocating market data revenues to the SROs. The Commission wishes to request additional comment on these issues.

A. Market Data Fees

Several panelists at the NMS Hearing addressed the current level of fees charged by the market data Networks and questioned whether such fees remain reasonably related to the cost of market data.[47] For example, a representative of Nasdaq stated that it recently had examined its costs and concluded that, instead of the current $20 monthly fee for professional investors to obtain basic data—NBBO and trades—in Nasdaq-listed stocks, the number should be approximately $5 to $7 per month.[48] He did not discuss, however, the costs incurred by Nasdaq to produce the full quotation data (''Level II data'') that is disseminated by Network C. Another panelist stated that the Networks should be required to disclose publicly the actual cost of providing market data to the public.[49] The Commission would welcome public comment addressing the reasonableness of market data fees and whether the Commission should modify its approach to reviewing such fees. As noted in the Proposing Release, one of the Commission's primary goals with respect to market data is to assure reasonable fees that promote the wide public availability of market information.[50] Indeed, an extensive public record has been developed on this issue over the last five years. This record includes the Commission's 1999 concept release on market information fees and revenues (''Concept Release''),[51] the public comments received in response to the Concept Release, and the 2001 report of the Commission's Advisory Committee on Market Information (''Advisory Committee'').[52] In formulating their comments on these matters, commenters are encouraged to consider and respond to the views reflected in the public record.

B. Revenue Allocation Formula

At the NMS Hearing, some panelists questioned the complexity and cost of the proposed formula for allocating market data revenues to the SROs. The Commission wishes to request supplemental comment on this issue.

First, the prospect that, in the future, displayed quotes for NMS stocks may be predominantly accessible through Auto-Ex Facilities presents an opportunity for simplifying the proposed formula. As proposed, the calculation of an SRO's Quoting Share, which would reward markets for the time and size of their quotes at the NBBO, would include an automatic cut-off when quotes that are not fully accessible through automatic execution are left alone at the NBBO. The purpose of the automatic cutoff for manual quotes was to minimize the reward for quotes that could be stale if in the process of being manually updated. The Commission requests comment on whether only quotes that are accessible through an Auto-Ex Facility should be considered in the allocation of market data revenues, thereby eliminating any need for the formula to include an automatic cutoff applicable to manual quotes.[53]

Second, comment is requested on whether, if manual quotes were excluded from the calculation of Quoting Shares, the proposed additional measure of quoting activity—the proposed NBBO Improvement Share—should be eliminated from the formula. The NBBO Improvement Share is significantly more complex than the other aspects of the formula, which essentially are calculated already by those who track the trading and quoting activity of market centers. The NBBO Improvement Share was designed primarily to single out and reward price leaders—those market centers that quote most aggressively by frequently displaying better prices and thereby helping to narrow quoted spreads. An additional measure of quoting activity was particularly important to offset the advantage that manual quotes could have in the calculation of Quoting Shares. Such manual quotes might merely match the prices set by other markets, yet not be accessed quickly because not automatically executable. As a result, manual quotes would tend to equal the NBBO for long periods of time merely because they were the least accessible quotes available at the price. If manual quotes were excluded from the calculation of Quoting Shares, the need for an additional quoting measure would be somewhat diminished. Comment is requested on whether the benefit of rewarding aggressive quote improvement justifies the increased complexity of calculating the NBBO Improvement Share.

Finally, although the Proposing Release itself recognized that the proposed formula is relatively complex, the difficulty and cost of implementing the formula may have been overstated at the NMS Hearing. No additional data is necessary to calculate the formula beyond the quote and trade data that

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[45] Section VI.C.2 and note 289 of the Proposing Release. The Proposing Release also noted that quotations displayed in the consolidated data stream often may be locked because one or both quotes may have a fee attached. Comment was requested on whether limiting fees to a *de minimis* amount would help address this problem. Section IV.B.4 of the Proposing Release.

[46] In Section IV.B.4 of the Proposing Release, the Commission requested comment on whether there should be an exception from the locked quotation provisions of proposed Rule 610(c) for quotations of automated markets that lock quotations that are only manually accessible. A similar exception could be made for quotations of *de minimis* fee markets that lock quotations with high fees.

[47] *See, e.g.*, Hearing Tr. at 223–224, 228–229, 230–231.

[48] Hearing Tr. at 223–224.

[49] Hearing Tr. at 230.

[50] Section VI.B of the Proposing Release.

[51] Securities Exchange Act Release No. 42208 (December 9, 1999), 64 FR 70613 (December. 17, 1999).

[52] Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change (September 14, 2001) (available at *http://www.sec.gov*).

[53] Comment was requested in section III.B above on whether, if access fees are not limited, quotes with fees of greater than a *de minimis* amount should be excluded from the allocation of market data revenue.

already is disseminated by the Network processors and stored by data vendors. The formula would not need to be calculated in real-time, nor would anyone other than the Network processors and other industry participants need to deal with the formula directly. Consequently, it does not appear that adoption of the formula would impose any additional ''downstream'' systems costs on vendors or broker-dealers. Indeed, if necessary, a single vendor could be retained by all three Networks to program and process the calculations required by the proposed formula, thereby potentially reducing the implementation costs by a significant amount. Comment is requested on the potential implementation costs of the proposed formula and on possible ways to minimize such costs.

V. General Request For Comment

In addition to the supplemental requests for comment set forth above, the Commission renews its requests for comment on the Regulation NMS proposals that were published in the Proposing Release. It particularly encourages the public to consider the significant matters discussed during the NMS Hearing when formulating their comments.

Dated: May 20, 2004.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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