**SECURITIES AND EXCHANGE COMMISSION**

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# REGULATION NMS

**AGENCY:** Securities and Exchange Commission.

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

**SUMMARY:** The Securities and Exchange Commission ("Commission") is adopting rules under Regulation NMS and two amendments to the joint industry plans for disseminating market information. In addition to redesignating the national market system rules previously adopted under Section 11A of the Securities Exchange Act of 1934 ("Exchange Act"), Regulation NMS includes new substantive rules that are designed to modernize and strengthen the regulatory structure of the U.S. equity markets. First, the "Order Protection Rule" requires trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by other trading centers, subject to an applicable exception. To be protected, a quotation must be immediately and automatically accessible. Second, the "Access Rule" requires fair and non-discriminatory access to quotations, establishes a limit on access fees to harmonize the pricing of quotations across different trading centers, and requires each national securities exchange and national securities association to adopt, maintain, and enforce written rules that prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross automated quotations. Third, the "Sub-Penny Rule" prohibits market participants from accepting, ranking, or displaying orders, quotations, or indications of interest in a pricing

increment smaller than a penny, except for orders, quotations, or indications of interest that are priced at less than $1.00 per share. Finally, the Commission is adopting amendments to the "Market Data Rules" that update the requirements for consolidating, distributing, and displaying market information, as well as amendments to the joint industry plans for disseminating market information that modify the formulas for allocating plan revenues ("Allocation Amendment") and broaden participation in plan governance ("Governance Amendment").

**DATES:** Effective Date: August 29, 2005.

Compliance Dates: For specific phase-in dates for compliance with the final rules and amendments, see section VII of this release.

**FOR FURTHER INFORMATION CONTACT:** Order Protection Rule: Heather Seidel, Senior Special Counsel, at (202) 551-5608, Marc F. McKayle, Special Counsel, at (202) 551-5633, David Hsu, Special Counsel, at (202) 551-5664, or Raymond Lombardo, Attorney, at (202) 551-5615; Access Rule: Heather Seidel, Senior Special Counsel, at (202) 551-5608, or David Liu, Attorney, at (202) 551-5645; Sub-Penny Rule: Michael Gaw, Senior Special Counsel, at (202) 551-5602; Market Data Rules, Allocation Amendment, and Governance Amendment: David Hsu, Special Counsel, at (202) 551-5664; Regulation NMS: Yvonne Fraticelli, Special Counsel, at (202) 551-5654; all of whom are in the Division of Market Regulation, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

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## I. Introduction

The Commission is adopting Regulation NMS, a series of initiatives designed to modernize and strengthen the national market system ("NMS") for equity securities.[1] These initiatives include:

(1) a new Order Protection Rule,[2] which reinforces the fundamental principle of obtaining the best price for investors when such price is represented by automated quotations that are immediately accessible;

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

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

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1 The Commission originally proposed Regulation NMS in February 2004. Securities Exchange Act Release No. 49325 (Feb. 26, 2004), 69 FR 11126 (Mar. 9, 2004) ("Proposing Release"). It issued a supplemental request for comment in May 2004. Securities Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 (May 26, 2004) ("Supplemental Release"). On December 16, 2004, the Commission reproposed Regulation NMS in its entirety for public comment. Securities Exchange Act Release No. 50870 (Dec. 16, 2004), 69 FR 77424 (Dec. 27, 2004) ("Reproposing Release").

2 Although the Reproposing Release referred to Rule 611 as the "Trade-Through Rule," the reproposed Rule itself was named "Order Protection Rule." The term "Trade-Through Rule" was used in the Reproposing Release to avoid confusion, given that the term had been widely used in public debate. The term "Order Protection Rule," however, better captures the nature of the adopted Rule. For example, the term helps distinguish the existing trade-through provisions for exchange-listed stocks, which do not really protect orders. Limit order users want a fast, efficient execution of their orders, not a slow, costly "satisfaction" process that is provided by the existing trade-through provisions. See infra, note 30 and accompanying text.

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

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

The Commission is adopting Regulation NMS in furtherance of its statutory responsibilities. In 1975, Congress directed the Commission, through enactment of Section 11A of the Exchange Act, to facilitate the establishment of a national market system to link together the multiple individual markets that trade securities. Congress intended the Commission to take advantage of opportunities created by new data processing and communications technologies to preserve and strengthen the securities markets. By incorporating such technologies, the NMS is designed to achieve the objectives of efficient, competitive, fair, and orderly markets that are in the public interest and protect investors. For three decades, the Commission has adhered to these guiding objectives in its regulation of the NMS, which are essential to meeting the investment needs of the public and reducing the cost of capital for listed companies. Over this period, the Commission has continued to revise and refine its NMS rules in light of changing market conditions.

Today, the NMS encompasses the stocks of more than 5000 listed companies, which collectively represent more than $14 trillion in U.S. market capitalization. Consistent with Congressional intent, these stocks are traded simultaneously at a variety of different venues that participate in the NMS, including national securities exchanges, alternative trading systems ("ATSs"), and market-making securities dealers. The Commission believes that the NMS approach adopted by Congress is a primary reason that the U.S. equity markets are widely recognized as being the fairest, most efficient, and most competitive in the world. The rules that the Commission is now adopting represent an important and needed step forward in its continuing implementation of Congress's objectives for the NMS. By modernizing and strengthening the nation's regulatory structure, the rules are designed to assure that the equity markets will continue to serve the interests of investors, listed companies, and the public for years to come.

In recent years, the equity markets have experienced sweeping changes, ranging from new technologies to new types of markets to the initiation of trading in penny increments. The pressing need for NMS modernization to reflect these changes is inescapable. Thus, for the last five years, the Commission has undertaken a broad and systematic review to determine how best to keep the NMS up-to-date. This review has required the Commission to grapple with many difficult and contentious issues that have lingered unresolved for many years. We have devoted a great deal of effort to studying these issues, listening to the views of the public, and have carefully considered the comments contained in the record to craft rule proposals that would achieve the statutory objectives for the NMS.

Given the wide range of perspectives on market structure issues, it is perhaps inevitable that there would be differences of opinion on the Commission's policy choices. The time has arrived, however, 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. The Commission always seeks to achieve consensus, but trying to achieve consensus should not impede the achievement of the statutory objectives for the NMS and should not damage the competitiveness of the U.S. equity markets, both at home and internationally. We believe that further delay is not warranted and therefore have adopted final rules needed to modernize and strengthen the NMS. The following discussion briefly summarizes the deliberate and open rulemaking process that the Commission has undertaken and the extensive record that supports the adoption of Regulation NMS, including the many empirical studies undertaken by the Commission staff.

### A. Summary of Rulemaking Process and Record

The Commission has engaged in a thorough, deliberate, and open rulemaking process that has provided at every point an opportunity for public participation and debate. We have actively sought out the views of the public and securities industry participants. Even prior to formulating proposals, our review included multiple public hearings and roundtables, an advisory committee, three concept releases, the issuance of temporary exemptions intended in part to generate useful data on policy alternatives, and a constant dialogue with industry participants and investors. This process continued after the proposals were published for public comment.[3] We held a public hearing on the proposals in April 2004 ("NMS Hearing") that included more than 30 panelists representing investors, individual markets, and market participants from a variety of different sectors of the securities industry.[4] Because we believed that there were a number of important developments at the public hearing, we published a supplemental request for comment and extended the comment period on the proposals in May 2004 to give the public a full opportunity to respond to these developments.[5] We then carefully considered the more than 700 comment letters submitted by the public, which encompassed a wide range of views.

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3 Proposing Release, 69 FR at 11126.

4 A list of all panelists and full transcript of the NMS Hearing ("Hearing Tr."), as well as an archived video and audio webcast, are available on the Commission's Internet Web site (http://www.sec.gov).

5 Supplemental Release, 69 FR at 30142.

The insights of the commenters, as well as those of the NMS Hearing panelists, contributed to significant refinements of the original proposals. In addition, the Commission staff prepared several studies of relevant trading data to help evaluate and respond to the views of commenters. Consequently, rather than immediately adopting rules, the Commission reproposed Regulation NMS in its entirety in December 2004 to afford the public an additional opportunity to review and comment on the details of the rules and on the staff studies. The Commission then received, and carefully considered, more than 1500 additional comments on the reproposal.[6]

This extensive rulemaking process has generated an equally extensive record, which is discussed at length throughout this release as it relates to each of the four substantive rulemaking initiatives. Indeed, substantial parts of the release are devoted to responding to the many public comments (particularly those opposing the proposals) and to discussing the estimated costs and benefits of the rules. This rulemaking raised difficult policy issues on which commenters submitted differing views. To move forward, the Commission necessarily has had to make policy decisions that not everyone will agree with.

The fact that each of the adopted rules provoked conflicting views from commenters should not, however, obscure the very substantial evidence in the record strongly supporting each of the four substantive rulemaking initiatives in Regulation NMS. Clearly, the Order Protection Rule was most controversial and attracted the most public comment and attention, yet

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6 The Reproposing Release stated that the Commission would continue to consider all comments received on the Proposing Release and Supplemental Release, in addition to those on the Reproposing Release, in evaluating further rulemaking action. 69 FR at 77426. Accordingly, this release discusses comments received in response to all three previous releases. Comments on the Proposing Release and Supplemental Release are referred to as "[name of commenter] Letter." Comments on the Reproposing Release are referred to as "[name of commenter] Reproposal Letter."

the breadth of support in the record for the Rule is compelling. Indeed, support for an intermarket price protection rule begins with the adoption by Congress in 1975 of the national market system itself. Both the House and Senate committees responsible for drafting Section 11A specifically considered and endorsed the Commission's authority to adopt a price protection rule as a means to achieve the statutory objectives for the NMS.[7]

Consistent with the drafters' views, a broad spectrum of commenters supported adoption of the Order Protection Rule for all NMS stocks, including investors, listed companies, individual markets, market participants, and academics.[8] Many individual and institutional investors particularly supported the Commission's view that significant problems exist that require the Commission to modernize its regulations. They also suggested the need for strengthened intermarket price protection to further their interests, as did major groups representing investors, such as the Investment Company Institute (whose mutual fund members manage assets of $7.8 trillion that account for more than 95% of all U.S. mutual fund assets), the Committee on Investment of Employee Benefit Assets (which represents 110 of the nation's largest corporate retirement funds managing $1.1 trillion on behalf of 15 million plan participants and beneficiaries), the National Association of Investors Corporation (whose membership consists of investment clubs and individual investors with aggregate personal investments of approximately $116 billion), and the Consumer Federation of America.

Moreover, the commenters' views on the need for an intermarket price protection rule were supported by the various empirical studies of trading data performed by Commission staff. These studies found, among other things, that an estimated 1 out of 40 trades for both NYSE and

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7 See infra, notes 920-922 and accompanying text.

8 See infra, notes 56-59, 939-941, 957-960, and accompanying text.

Nasdaq stocks are executed at prices inferior to the best displayed quotations, or approximately 98,000 trades per day in Nasdaq stocks alone.[9] While the Commission believes that the total number of trade-throughs should not be the sole consideration in making its policy choices, the staff studies and analyses demonstrate that trade-through rates are significant and indicate the need for strengthened order protection for all NMS stocks.

Why did a broad spectrum of commenters, many of which have extensive experience and expertise regarding the inner workings of the equity markets, support the Order Protection Rule and its emphasis on the principle of best price? They based their support on two fundamental rationales, with which the Commission fully agrees. First, strengthened assurance that orders will be filled at the best prices will give investors, particularly retail investors, greater confidence that they will be treated fairly when they participate in the equity markets. Maintaining investor confidence is an essential element of well-functioning equity markets. Second, protection of the best displayed and accessible prices will promote deep and stable markets that minimize investor transaction costs. More than 84 million individual Americans participate, directly or indirectly, in the U.S. equity markets.[10] The transaction costs associated with the prices at which their orders are executed represent a continual drain on their long-term savings. Although these costs are difficult to calculate precisely, they are very real and very substantial, with estimates ranging from $30 billion to more than $100 billion per year.[11] Minimizing these investor costs to the greatest extent possible is the hallmark of efficient markets, which is a primary objective of the NMS. The Order Protection Rule is needed to help achieve this objective, thereby improving the

9 See infra, notes 66-69, 104, and accompanying text.

10 See infra, notes 25-26 and accompanying text.

11 See infra, note 990.

long-term financial well-being of millions of investors and reducing the cost of capital for listed companies.

In sum, the rules adopted today are the culmination of a long and comprehensive rulemaking process. Reaching appropriate policy decisions in an area as complex as market structure requires an understanding of the relevant facts and of the often subtle ways in which the markets work, as well as the balancing of policy objectives that sometimes may not point in precisely the same direction. Based on the extensive record that we have developed over the course of the rulemaking process, the Commission firmly believes that Regulation NMS will protect investors, promote fair competition, and enhance market efficiency, and therefore fulfills its Exchange Act responsibility to facilitate the development of the NMS.

## B. NMS Principles and Objectives

### 1. Competition Among Markets and Competition Among Orders

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

Accordingly, the Commission's primary challenge in facilitating the establishment of an NMS has been to maintain an appropriate <u>balance</u> between these two vital forms of competition.

It particularly has sought to avoid the extremes of: (1) isolated markets that trade an NMS stock without regard to trading in other markets and thereby fragment the competition among buyers and sellers in that stock; and (2) a totally centralized system that loses the benefits of vigorous competition and innovation among individual markets. Achieving this objective and striking the proper balance clearly can be a difficult task. Since Congress mandated the establishment of an NMS in 1975, the Commission frequently has resisted suggestions that it adopt an approach focusing on a single form of competition that, while perhaps easier to administer, would forfeit the distinct, but equally vital, benefits associated with both competition among markets and competition among orders.

With respect to competition among markets, for example, the record of the last thirty years should give pause to those who believe that any market structure regulation is inherently inconsistent with vigorous market competition. Other countries with significant equity trading typically have a single, overwhelmingly dominant public market.[12] The U.S., in contrast, is fortunate to have equity markets that are characterized by extremely vigorous competition among a variety of different types of markets. These include: (1) traditional exchanges with active trading floors, which even now are evolving to expand the range of choices that they offer investors for both automated and manual trading; (2) purely electronic markets, which offer both standard limit orders and conditional orders that are designed to facilitate complex trading strategies; (3) market-making securities dealers, which offer both automated execution of smaller orders and the commitment of capital to facilitate the execution of larger, institutional orders; (4) regional exchanges, many of which have adopted automated systems for executing smaller

[12] These markets include the London Stock Exchange in the United Kingdom, the Tokyo Stock Exchange in Japan, Euronext in France, and the Deutsche Bourse in Germany.

orders; and (5) automated matching systems that permit investors, particularly large institutions, to seek counter-parties to their trades anonymously and with minimal price impact.

In sum, while NMS regulation may channel specific types of market competition (e.g., by mandating the display to investors of consolidated prices and including the prices displayed internally by significant electronic markets), it has been remarkably successful in promoting market competition in its broader forms that are most important to investors and listed companies.

The difficulty, however, is that competition among multiple markets trading the same stocks can detract from the most vigorous competition among orders in an individual stock, thereby impeding efficient price discovery for orders of all sizes. The importance of competition among orders has long been recognized. Indeed, when Congress mandated the establishment of an NMS, it well stated this basic principle: "Investors must be assured that they are participants in a system which maximizes the opportunities for the most willing seller to meet the most willing buyer."[13] To the extent that competition among orders is lessened, the quality of price

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13 H.R. Rep. 94-123, 94th Cong., 1st Sess. 50 (1975). The quotation from the text of the House Report concludes a cogent description of the importance of maintaining the proper balance between competition among markets and competition among orders that is worth quoting in full:

> Critics of this development [multiple trading of stocks] suggest that the markets are becoming dangerously fragmented. Others contend that the dilution of large market dominance is the result of healthy competitive forces which have done much to add to the liquidity and depth of the securities markets to the benefit of the investing public. The Committee shares the opinion that our markets will be strengthened by the infusion of marketmaker competition in listed securities with the concomitant increase in capital availability and diminution of risk which results from increased competition among specialists and marketmakers. Nonetheless, market fragmentation becomes of increasing concern in the absence of mechanisms designed to assure that public investors are able to obtain the best price for securities regardless of the type or physical location of the market upon which his transaction may be executed. Investors must be

discovery for all sizes of orders can be compromised. Impaired price discovery could cause market prices to deviate from fundamental values, reduce market depth and liquidity,[14] and create excessive short-term volatility that is harmful to long-term investors and listed companies. More broadly, when market prices do not reflect fundamental values, resources will be misallocated within the economy and economic efficiency – as well as market efficiency – will be impaired.

### 2. Serving the Interests of Long-Term Investors and Listed Companies

In its extended review of market structure issues and in assessing how best to achieve an appropriate balance between competition among markets and competition among orders, the Commission has been guided by a firm belief that one of the most important goals of the equity markets is to minimize the transaction costs of long-term investors and thereby to reduce the cost of capital for listed companies. These functions are inherently related because the cost of capital

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> assured that they are participants in a system which maximizes the opportunities for the most willing seller to meet the most willing buyer.

Id.

14 The Proposing Release and Reproposing Release frequently emphasized the importance of promoting greater depth and liquidity. Some commenters appeared to equate depth and liquidity with other factors, such as trading volume and frequency of quotation updates. See, e.g., Letter from Edward J. Nicoll, Chief Executive Officer, Instinet Group Incorporated, to Jonathan G. Katz, Secretary, Commission, dated Jan. 26, 2005 ("Instinet Reproposal Letter") at 9; Letter from Marc E. Lackritz, President, Securities Industry Association, to Jonathan G. Katz, Secretary, Commission, dated Feb. 1, 2005 ("SIA Reproposal Letter") at 12. The Commission, however, uses the terms specifically to refer to the ability of investors to trade in large size at low cost and in general to a market's capacity to absorb order imbalances with minimized price impact. Depth is measured in terms of the volume of stock that can be readily traded at a particular price point. Liquidity is measured by the price movement experienced by investors when attempting to trade in large size. See infra, section II.A.6 (estimate of transaction costs for equity mutual funds). Although depth and liquidity are correlated with trading volume, they are not synonymous. For example, one stock might have less trading volume than another stock, but still have greater depth available at and close to the best quoted prices and lower transaction costs for large institutional investors.

of listed companies is influenced by the transaction costs of those who are willing to accept the risk of holding corporate equity for an extended period.[15]

The Reproposing Release touched on this issue in the specific context of assessing the effect of the Order Protection Rule on the interests of professional traders in conducting extremely short-term trading strategies that can depend on millisecond differences in order response time from markets. Noting that any protection against trade-throughs could interfere to some extent with such short-term trading strategies, the release framed the Commission's policy choice as follows: "Should the overall efficiency of the NMS defer to the needs of professional traders, many of whom rarely intend to hold a position overnight? Or should the NMS serve the needs of longer-term investors, both large and small, that will benefit substantially from intermarket price protection?"[16] The Reproposing Release emphasized that the NMS must meet the needs of longer-term investors, noting that any other outcome would be contrary to the Exchange Act and its objectives of promoting fair and efficient markets that serve the public interest.[17]

In response, some commenters disputed this focus on the interests of long-term investors in formulating Regulation NMS, one even questioning the Commission's statutory authority to do so.[18] Others commenters appeared to share this view, as evidenced by their downplaying, or

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15 Investors are more willing to own a stock if it can be readily traded in the secondary market with low transaction costs. The greater the willingness of investors to own a stock, the higher its price will be, thereby reducing the issuer's cost of capital.

16 Reproposing Release, 69 FR at 77440.

17 Id.

18 Letter from Phylis M. Esposito, Executive Vice President, Chief Strategy Officer, Ameritrade, Inc., to Jonathan G. Katz, Secretary, Commission, dated Jan. 26, 2005 ("Ameritrade Reproposal Letter") at 9 (among other issues, questioning Commission's statutory authority); Letter from James A. Duncan, Chairman, and John C. Giesea,

failing entirely to address, indications of a need for improvements in market quality that are important to long-term investors, such as minimizing short-term price volatility.[19]

Most of the time, the interests of short-term traders and long-term investors will not conflict. Short-term traders clearly provide valuable liquidity to the market. But when the interests of long-term investors and short-term traders diverge, few issues are more fundamentally important in formulating public policy for the U.S. equity markets than the choice between these interests. While achieving the right balance of competition among markets and competition among orders will always be a difficult task, there will be no possibility of accomplishing it if in the case of a conflict the Commission cannot choose whether the U.S. equity markets should meet the needs of long-term investors or short-term traders.

The objective of minimizing short-term price volatility offers an important example where the interests of long-term investors can diverge from those of short-term traders. Deep and liquid markets that minimize volatility are of most benefit to long-term investors. Such markets help reduce transaction costs by furthering the ability of investors to establish and unwind positions in a stock at prices that are as close to previously prevailing prices as possible. Indeed, the 1975 Senate Report on the NMS emphasized that one of the "paramount" objectives

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President and CEO, Security Traders Association, to Jonathan G. Katz, Secretary, Commission, dated Jan. 19, 2005 ("STA Reproposal Letter") at 6; Letter from William A. Vance, Stephen Kay, and Kimberly Unger, The Security Traders Association of New York, Inc., dated Jan. 24, 2005 ("STANY Reproposal Letter") at 8 n. 18.

19 See, e.g., Instinet Reproposal Letter at 7-8 ("We further believe there is no basis for the Commission's assertion that the reproposed trade-through rule would increase fill rates or reduce transitory volatility on the Nasdaq market (or, for that matter, whether these are in fact 'weaknesses' that need to be addressed."). Short-term price volatility for Nasdaq stocks is discussed further in section II.A.1.b below.

for the NMS is "the maintenance of stable and orderly markets with maximum capacity for absorbing trading imbalances without undue price movements."[20]

Excessively volatile markets, in contrast, can generate many opportunities for traders to earn short-term profits from rapid price swings. Short-term traders, in particular, typically possess the systems capabilities and expertise necessary to enter and exit the market rapidly to exploit such price swings. Moreover, short-term traders have great flexibility in terms of their choice of stocks, choice of initially establishing a long or short position, and time of entering and exiting the market. Long-term investors (both institutional and retail), in contrast, typically have an opinion on the long-term prospects for a company. They therefore want to buy or sell a particular stock at a particular time. These investors thus are inherently less able to exploit short-term price swings and, indeed, their buying or selling interest often can initiate short-term price movements.[21] Efficient markets with maximum liquidity and depth minimize such price movements and thereby afford long-term investors an opportunity to achieve their trading objectives with the lowest possible transaction costs.

The Commission recognizes that it is important to avoid false dichotomies between the interests of short-term traders and long-term investors, and that many difficult line-drawing issues potentially can arise in precisely defining the difference between the two terms. For

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20 S. Rep. No. 94-75, 94th Cong., 1st Sess. 7 (1975).

21 Long-term investors, of course, also can be interested in fast executions. One of the primary effects of the Order Protection Rule adopted today will be to promote much greater speed of execution in the market for exchange-listed stocks. The difference in speed between automated and manual markets often is the difference between a 1-second response and a 15-second response – a disparity that clearly can be important to many investors.

present purposes, however, these issues can be handled by simply noting that it makes little sense to refer to someone as "investing" in a company for a few seconds, minutes, or hours.[22]

Short-term traders and market intermediaries unquestionably provide needed liquidity to the equity markets and are essential to the welfare of investors. Consequently, much, if not most, of the time the interests of long-term investors and short-term traders in market quality issues such as speed and operational efficiency will coincide. Indeed, implementation of Regulation NMS likely will lead to a significant expansion of automated trading in exchange-listed stocks that both benefits all investors and opens up greater potential for electronic trading in such stocks than currently exists. But when the interests of long-term investors and short-term traders conflict in this context, the Commission believes that its clear responsibility is to uphold the interests of long-term investors.

Indeed, the core concern for the welfare of long-term investors who depend on equity investments to meet their financial goals was first expressed in the foundation documents of the Exchange Act itself. In language that remains remarkably relevant today, the 1934 congressional reports noted how the national public interest of the equity markets had grown as more and more Americans had begun to place their savings in equity investments, both directly and indirectly through investment intermediaries.[23] Given this development, the reports emphasized that "stock

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22 The concept of ownership for a significant time period is inherent in the meaning of word "invest." A dictionary definition of "investor," for example, is "one that seeks to commit funds for long-term profit with a minimum of risk." Webster's Third New International Dictionary of the English Language 1190 (Unabridged 1993).

23 H.R. Rep. No. 1383, 73rd Cong., 2d Sess. 3-4 (1934) ("It is estimated that more than 10,000,000 individual men and women in the United States are the direct possessors of stocks and bonds; that over one-fifth of all the corporate stock outstanding in the country is held by individuals with net incomes of less than $5,000 a year. Over 15,000,000 individuals held insurance policies, the value of which is dependent on the security holdings of insurance companies. Over 13,000,000 men and women have savings accounts in mutual savings banks and at least 25,000,000 have deposits in national and

exchanges which handle the distribution and trading of a very substantial part of the entire national wealth . . . cannot operate under the same traditions and practices as pre-war stock exchanges which handled substantially only the transactions of professional investors and speculators."[24]

In the years since 1934, the priority placed by Congress on the interests of long-term investors has grown more and more significant. Today, more than 84 million individuals representing more than one-half of American households own equity securities.[25] More than 70 million of these individuals participate indirectly in the equity markets through ownership of mutual fund shares. Most of them hold their investments, at least in part, in retirement plans. Indeed, nearly all view their equity investments as savings for the long-term, and their median

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State banks and trust companies – which are in turn large holders of corporate stocks and bonds.").

24 Id. at 4. The Congressional emphasis on the interests of long-term investors versus short-term traders also was expressed in the 1934 Report on Stock Exchange Practices prepared by investigators for the Senate Committee on Banking and Currency:

> Transactions in securities on organized exchanges and over-the-counter markets are affected with the national public interest. . . . In former years transactions in securities were carried on by a relatively small portion of the American people. During the last decade, however, due largely to the development of the means of communication . . . the entire Nation has become acutely sensitive to the activities on the securities exchanges. While only a fraction of the multitude who now own securities can be regarded as actively trading on the exchanges, the operations of these few profoundly affect the holdings of all.

S. Rep. No. 73-1455, 73rd Cong., 2d Sess. 5 (1934).

25 Investment Company Institute and Securities Industry Association, Equity Ownership in America 17 (2002).

length of ownership of equity mutual funds, both inside and outside retirement plans, is 10 years.[26]

In assessing the current state of the NMS and formulating its rule proposals, the Commission has focused on the interests of these millions of Americans who depend on the performance of their equity investments for such vital needs as retirement security and their children's college education. Their investment returns are reduced by transaction costs of all types, including the explicit costs of commissions and mutual fund fees. But the largely hidden costs associated with the prices at which trades are executed often can dwarf the explicit costs of trading. For example, the implicit transaction costs associated with the price impact of trades and liquidity search costs of mutual funds and other institutional investors is estimated at more than $30 billion per year.[27] Such hidden costs eat away at the long-term returns of millions of individual mutual fund shareholders and pension plan participants. One of the primary objectives of the NMS is to help reduce such costs by improving market liquidity and depth. The best way to promote market depth and liquidity is to encourage vigorous competition among orders. As a result, the Commission cannot merely focus on one type of competition – competition among markets to provide trading services – at the expense of competition among orders. The interests of U.S. long-term investors and listed companies require that the NMS continue to promote both types of competition.

### C. Overview of Adopted Rules

#### 1. Order Protection Rule

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[26] Id. at 85, 89, 92, 96.

[27] See infra, section II.A.6.

The Order Protection Rule (Rule 611 under Regulation NMS) establishes intermarket protection against trade-throughs for all NMS stocks. A trade-through occurs when one trading center executes an order at a price that is inferior to the price of a protected quotation, often representing an investor limit order, displayed by another trading center.[28] Many commenters on the proposals, particularly large institutional investors, strongly supported the need for enhanced protection of limit orders against trade-throughs.[29] They emphasized that limit orders are the building blocks of public price discovery and efficient markets. They stated that a uniform rule for all NMS stocks, by enhancing protection of displayed prices, would encourage greater use of limit orders and contribute to increased market liquidity and depth. The Commission agrees that strengthened protection of displayed limit orders would help reward market participants for displaying their trading interest and thereby promote fairer and more vigorous competition among orders seeking to supply liquidity. Moreover, strong intermarket price protection offers greater assurance, on an order-by-order basis, that investors who submit market orders will receive the best readily available prices for their trades. The Commission therefore has adopted the Order Protection Rule to strengthen the protection of displayed and automatically accessible quotations in NMS stocks.

The Order Protection Rule takes a substantially different approach than the trade-through provisions currently set forth in the Intermarket Trading System ("ITS") Plan,[30] which apply only

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28 The nature and scope of quotations that will be protected under the Order Protection Rule are discussed in detail in sections II.A.2 and II.B.1 below.

29 See infra, note 56 (overview of commenters supporting trade-through proposal).

30 The full title of the ITS Plan is "Plan for the Purpose of Creating and Operating an Intermarket Communications Linkage Pursuant to Section 11A(c)(3)(B) of the Securities Exchange Act of 1934." The ITS Plan was initially approved by the Commission in 1978. Securities Exchange Act Release No. 14661 (Apr. 14, 1978), 43 FR 17419 (Apr. 24, 1978). All national securities exchanges that trade exchange-listed stocks and the

to exchange-listed stocks. The ITS provisions are not promulgated by the Commission, but rather are rules of the markets participating in the ITS Plan. These rules were drafted decades ago and do not distinguish between manual and automated quotations. Moreover, they state that markets "should avoid" trade-throughs and provide an after-the-fact complaint procedure pursuant to which, if a trade-through occurs, the aggrieved market may seek satisfaction from the market that traded through. Finally, the ITS provisions have significant gaps in their coverage, particularly for off-exchange positioners of large, block transactions (10,000 shares or greater), that have weakened their protection of limit orders.

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

In addition, the Order Protection Rule incorporates an approach to trade-throughs that is stricter and more comprehensive than the ITS provisions. First, it requires trading centers to

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NASD are participants in the ITS Plan. It requires each participant to provide electronic access to its displayed best bid or offer to other participants and provides an electronic mechanism for routing orders, called commitments to trade, to access those displayed prices. The participants also agreed to avoid trade-throughs and locked markets and to adopt rules addressing such practices.

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

The definition of "protected bid" or "protected offer" in paragraph (b)(57) of adopted Rule 600 controls the scope of quotations that are protected by the Order Protection Rule. The Commission is adopting the reproposed "Market BBO Alternative" that protects only the best bids and offers ("BBOs") of the nine self-regulatory organizations ("SROs") and The Nasdaq Stock Market, Inc. ("Nasdaq") whose members currently trade NMS stocks. As discussed further in section II.A.5 below, the Commission has decided not to adopt the reproposed "Voluntary Depth Alternative." In particular, it believes that the Market BBO Alternative: (1) strikes an appropriate balance between competition among markets and competition among orders; and (2) will be less difficult and costly to implement than the Voluntary Depth Alternative.

The rule text of the original proposal included a general "opt-out" exception that would have allowed market participants to disregard displayed quotations. While the opt-out proposal was intended to provide flexibility to market participants, such an exception would have left a gap in protection of the best displayed prices and thereby reduced the proposal's potential benefits for investors. The elimination of any protection for manual quotations is the principal reason that this broad exception is no longer necessary in the Order Protection Rule as adopted. In addition, the Rule adds a number of tailored exceptions that carve out those situations in which many investors may otherwise have felt they legitimately needed to opt-out of a displayed quotation. These exceptions are more consistent with the principle of protecting the best price than a general opt-out exception would have been. The additional exceptions also will help assure that the Order Protection Rule is workable for high-volume stocks. Examples of these exceptions include intermarket sweep orders, quotations displayed by markets that fail to meet the response requirements for automated quotations, and flickering quotations with multiple prices displayed in a single second.[31]

Some commenters questioned the need to extend the Order Protection Rule to Nasdaq stocks.[32] These commenters generally emphasized the much improved efficiency of trading in Nasdaq stocks in recent years. They particularly were concerned that extension of intermarket price protection to Nasdaq stocks, at least in the absence of a general opt-out exception, would interfere with current trading methods.

The Commission believes, however, that intermarket price protection will benefit investors and strengthen the NMS in both exchange-listed and Nasdaq stocks. It will contribute

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31 Flickering quotations are discussed further in section II.A.3 below.

32 See infra, notes 61-62 and accompanying text.

to the maintenance of fair and orderly markets and, thereby, promote investor confidence in the markets. As discussed below,[33] trade-through rates are significant in both Nasdaq and exchange-listed stocks. For example, an estimated 1 of every 40 trades in both Nasdaq and NYSE stocks represents a significant trade-through of a displayed quotation. For many active Nasdaq stocks, approximately 1 of every 11 shares traded is a significant trade-through. The execution of trades at prices inferior to those offered by displayed and accessible limit orders is inconsistent with basic notions of fairness and orderliness, particularly for investors, both large and small, who post limit orders and see those orders routinely traded through. These trade-throughs can undermine incentives to display limit orders. Moreover, many of the investors whose market orders are executed at inferior prices may not, in fact, be aware they received an inferior price from their broker and executing market. In sum, the Commission believes that a rule establishing price protection on an order-by-order basis for all NMS stocks is needed to protect the interests of investors, promote the display of limit orders, and thereby improve the efficiency of the NMS as a whole.

**2. Access Rule**

The Access Rule (Rule 610 under Regulation NMS) sets forth new standards governing access to quotations in NMS stocks. As emphasized by many commenters on the proposals,[34] protecting the best displayed prices against trade-throughs would be futile if broker-dealers and trading centers were unable to access those prices fairly and efficiently. Accordingly, Rule 610 is designed to promote access to quotations in three ways. First, it enables the use of private

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33 See infra, section II.A.1.a.ii.

34 See infra, section III.A.1.

linkages offered by a variety of connectivity providers,[35] rather than mandating a collective linkage facility such as ITS, to facilitate the necessary access to quotations. The lower cost and increased flexibility of connectivity in recent years has made private linkages a feasible alternative to hard linkages, absent barriers to access. Using private linkages, market participants may obtain indirect access to quotations displayed by a particular trading center through the members, subscribers, or customers of that trading center. To promote this type of indirect access, Rule 610 prohibits a trading center from imposing unfairly discriminatory terms that would prevent or inhibit the access of any person through members, subscribers, or customers of such trading center.

Second, Rule 610 generally limits the fees that any trading center can charge (or allow to be charged) for accessing its protected quotations to no more than $0.003 per share.[36] The purpose of the fee limitation is to ensure the fairness and accuracy of displayed quotations by establishing an outer limit on the cost of accessing such quotations. For example, if the price of a protected offer to sell an NMS stock is displayed at $10.00, the total cost to access the offer and buy the stock will be $10.00, plus a fee of no more than $0.003. The adopted rule thereby assures order routers that displayed prices are, within a limited range, true prices.

The adopted fee limitation substantially simplifies the originally-proposed limitation on fees, which, in general, would have limited the fees of individual market participants to $0.001 per share, with an accumulated cap of $0.002 per share. Perhaps more than any other single

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35 Private linkages are discussed further in section III.A.1 below.

36 If the price of a protected quotation is less than $1.00, the fee cannot exceed 0.3% of the quotation price. The rule as adopted also applies the fee limitation to quotations other than protected quotations that are the BBOs of an SRO or Nasdaq. See infra, section III.A.2.

issue, the proposed limitation on access fees splintered the commenters.[37] Some supported the proposal as a worthwhile compromise on an extremely difficult issue. They believed that it would level the playing field in terms of who could charge fees, as well as give greater certainty to market participants that quoted prices will, essentially, be true prices. Others were strongly opposed to any limitation on fees, believing that competition alone would be sufficient to address high fees that distort quoted prices. Still others were equally adamant that all access fees of electronic communications networks ("ECNs") charged to non-subscribers should be prohibited entirely, although they did not see a problem with fees charged to a market's members or subscribers. Although consensus could not be achieved on any particular approach, commenters expressed a strong desire for resolution of a difficult issue that has caused discord within the securities industry for many years.

The Commission believes that a single, uniform fee limitation of $0.003 per share is the fairest and most appropriate resolution of the access fee issue. First, it will not seriously interfere with current business practices, as trading centers have very few fees on their books of more than $0.003 per share or earn substantial revenues from such fees.[38] Second, the uniform fee limitation promotes equal regulation of different types of trading centers, where previously some had been permitted to charge fees and some had not. Finally and most importantly, the fee limitation of Rule 610 is necessary to support the integrity of the price protection requirement established by the adopted Order Protection Rule. In the absence of a fee limitation, some "outlier" trading centers might take advantage of the requirement to protect displayed quotations by charging exorbitant fees to those required to access the outlier's quotations. Rule 610's fee

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[37] The comments on access fees are addressed in section III.A.2 below.

[38] See infra, section III.A.2.

limitation precludes the initiation of this business practice, which would compromise the fairness and efficiency of the NMS.

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

### 3. Sub-Penny Rule

The Sub-Penny Rule (adopted Rule 612 under Regulation NMS) prohibits market participants from displaying, ranking, or accepting quotations in NMS stocks that are priced in an increment of less than $0.01, unless the price of the quotation is less than $1.00. If the price of the quotation is less than $1.00, the minimum increment is $0.0001. A strong consensus of commenters supported the sub-penny proposal as a means to promote greater price transparency and consistency, as well as to protect displayed limit orders.[39] In particular, Rule 612 addresses the practice of "stepping ahead" of displayed limit orders by trivial amounts. It therefore should further encourage the display of limit orders and improve the depth and liquidity of trading in NMS stocks.

### 4. Market Data Rules and Plans

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[39] The comments on the sub-penny proposal are discussed in section IV.C below.

The adopted amendments to the Market Data Rules (adopted Rules 601 and 603 under Regulation NMS) and joint industry plans ("Plans")[40] are designed to promote the wide availability of market data and to allocate revenues to SROs that produce the most useful data for investors. They will strengthen the existing market data system, which provides investors in the U.S. equity markets with real-time access to the best quotations and most recent trades in the thousands of NMS stocks throughout the trading day. For each stock, quotations and trades are continuously collected from many different trading centers and then disseminated to the public in a consolidated stream of data. As a result, investors of all types have access to a reliable source of information for the best prices in NMS stocks. When Congress mandated the creation of the NMS in 1975, it noted that the systems for disseminating consolidated market data would "form the heart of the national market system."[41] Accordingly, one of the Commission's most important responsibilities is to preserve the integrity and affordability of the consolidated data stream.

The adopted amendments promote this objective in several different respects. First, they update the formulas for allocating revenues generated by market data fees to the various SRO participants in the Plans. The current Plan formulas are seriously flawed by an excessive focus on the number of trades, no matter how small the size, reported by an SRO. They thereby create

40 The three joint-industry plans are (1) the CTA Plan, which is operated by the Consolidated Tape Association and disseminates transaction information for exchange-listed securities, (2) the CQ Plan, which disseminates consolidated quotation information for exchange-listed securities, and (3) the Nasdaq UTP Plan, which disseminates consolidated transaction and quotation information for Nasdaq-listed securities. The CTA Plan and CQ Plan are available at www.nysedata.com. The Nasdaq UTP Plan is available at www.utpdata.com.

41 H.R. Rep. No. 94-229, 94th Cong., 1st Sess. 93 (1975).

an incentive for distortive behavior, such as wash sales and trade shredding,[42] and fail to reflect an SRO's contribution to the best displayed quotations in NMS stocks. The adopted formula corrects these flaws. It also is much less complex than the original proposal, primarily because, consistent with the approach of the Order Protection Rule and Access Rule, the new formula eliminates any allocation of revenues for manual quotations. It therefore will promote an allocation of revenues to the various SROs that more closely reflects the usefulness to investors of each SRO's market information.

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

Many commenters on the market data proposals expressed frustration with the current operation of the Plans.[43] These commenters generally fell into two groups. One group, primarily made up of individual markets that receive market data fees, believed that the current model of consolidation should be discarded in favor of a new model, such as a "multiple consolidator" model under which each SRO would sell its own data separately. The other group, primarily made up of securities industry participants that pay market data fees, believed that the current

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[42] Trade shredding, or the splitting of large trades into a series of 100-share trades, is discussed further in section V.A.3 below.

[43] Comments on the market data proposals are discussed in section V.A below.

level of fees is too high. This group asserted that, prior to modifying the allocation of market data revenues, the Commission should address the level of fees that generated those revenues.[44]

The Commission has considered these concerns at length in the recent past. As was noted in the Proposing Release,[45] a drawback of the current market data model, which requires all SROs to participate jointly in disseminating data through a single consolidator, is that it affords little opportunity for market forces to determine the overall level of fees or the allocation of those fees to the individual SROs. Prior to publishing the proposals, therefore, the Commission undertook an extended review of the various alternatives for disseminating market data to the public in an effort to identify a better model. These alternatives were discussed at length in the Proposing Release, but each has serious weaknesses. The Commission particularly is concerned that the integrity and reliability of the consolidated data stream must not be compromised by any changes to the market data structure.

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

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44 Some commenters mistakenly believed that the level of market data fees had been left unreviewed for many years. In fact, the Commission comprehensively reviewed market data fees in 1999, which led to a 75% reduction in fees paid by retail investors for market data. See infra, note 574.

45 Proposing Release, 69 FR at 11177.

The Commission also has considered the suggestion of many in the second group of commenters that market data fees should be cut back to encompass only the costs of the Plans to collect and disseminate market data. Under this approach, the individual SROs would no longer be allowed to fund any portion of their operational and regulatory functions through market data fees.[46] Yet, as discussed in the Commission's 1999 concept release on market data,[47] nearly the entire burden of collecting and producing market data is borne by the individual markets, not by the Plans. If, for example, an SRO's systems fail on a high-volume trading day and it can no longer provide its data to the Plans, investors will suffer the consequences of a flawed data stream, regardless of whether the Plan is able to continue operating.

If the Commission were to limit market data fees to cover only Plan costs, SRO funding would have been cut by $393.7 million in 2004.[48] Given the potential harm if vital SRO functions are not adequately funded, the Commission believes that the level of market data fees is most appropriately addressed in a context that looks at SRO funding as a whole. It therefore has requested comment on this issue in its recent concept release on SRO structure.[49] In

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46 The U.S. equity markets are not alone in their reliance on market information revenues as a significant source of funding. All of the other major world equity markets currently derive large amounts of revenues from selling market information. See infra, note 587 and accompanying text.

47 Securities Exchange Act Release No. 42208 (Dec. 9, 1999), 64 FR 70613 (Dec. 17, 1999) ("Market Information Release").

48 See infra, text accompanying note 564 (table setting forth revenue allocations for 2004).

49 Securities Exchange Act Release No. 50700 (Nov. 18, 2004), 69 FR 71256 (Dec. 8, 2004) ("SRO Structure Release").

addition, the recently proposed rules to improve SRO transparency would, if adopted, assist the public in assessing the level and use of market data fees by the various SROs.[50]

In sum, there is inherent tension between assuring consolidated price transparency for investors, which is a fundamental objective of the Exchange Act,[51] and expanding the extent to which market forces determine market data fees and SRO revenues. Each alternative model for data dissemination has its particular strengths and weaknesses. The great strength of the current model, however, is that it benefits investors, particularly retail investors, by helping them to assess quoted prices at the time they place an order and to evaluate the best execution of their orders against such prices by obtaining data from a single source that is highly reliable and comprehensive. In the absence of full confidence that this benefit would be retained if a different model were adopted, the Commission has decided to adopt such immediate steps as are necessary to improve the operation of the current model.

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50 Securities Exchange Act Release No. 50699 (Nov. 18, 2004), 69 FR 71126 (Dec. 8, 2004) ("SRO Transparency Release").

51 Section 11A(a)(1)(C)(iii) of the Exchange Act.

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