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Mr. Joel Seligman
Dean and Ethan A. H. Shipley University Professor
Washington University School of Law
1 Brookings Drive
Campus Box 1120
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Re: SEC Oversight of Enhanced Data Offered by Registered Exchanges

Dear Dean Seligman:

We read with great interest Rick Ketchum's June 14 memo suggesting a three-tiered approach to modernizing SEC oversight of market data fees charged by registered exchanges.[1] Rick distinguishes between "enhanced data" and "commercial products and services".[2] While we very much agree with Rick's general approach, we think sound public

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[1] This letter uses "registered exchange" to distinguish national securities exchanges (including NASDAQ prospectively) from other market centers that fall within the 1934 Act's definition of an "exchange" but are exempted from section 6 registration, such as ECNs and foreign exchanges doing a limited business in the US.

[2] Rick's memo also addresses a third tier, bid-asked quotes and last sale prices, which he denominates as "mandatory minimum information". While this letter focuses on enhanced data, let me note that we also disagree with Rick's suggestion that fees for quotes and prices currently are "required" to receive affirmative SEC approval. The relevant SEC rule, Rule 11Aa3-2, has always permitted a registered exchange to make fees for quotes and prices effective on filing. The rule follows section 19(b) in excepting fee filings from SEC pre-approval.

The Committee's work establishes no basis for *increasing* the regulatory and competitive burdens on registered exchanges regarding fees for quotes and prices. Indeed, to the contrary, competition among consolidators resulting from our withdrawal from the market data consortia strengthens our core argument that the constituent boards of registered exchanges are the primary mechanism for assuring that fees for quotes and prices are equitably allocated, fair and reasonable and not unreasonably discriminatory. As we have spelled out during the Committee's work, Congress appropriately placed the SEC in a "just-in-case" role as to exchange fees for prices and quotes by giving the SEC abrogation authority rather than responsibility for pre-approval.

policy argues against his distinction. We suggest that, as for commercial products and services, exchange fees for enhanced data offerings ought not to be subject to SEC oversight,[3] although subject to a confidential information filing. Rather than argue abstractly, I develop this case below by analyzing one type of enhanced data, limit order data.

Need the SEC Oversee Exchange Fees for Limit Order Data?

Exclusivity: Both the full Committee and the Langevoort Subcommittee discussed on several occasions the circumstances under which market (pricing) power could arise, especially in debating whether to retain the "display rule", Rule 11Ac1-2. We recall no Committee member disputing that direct SEC fee oversight should diminish as actual or potential competition increases. This echoes the approach taken by the 1934 Act regarding the registration of processors of quotes and prices (Rick's "mandatory minimum information"): the statute mandates the registration of "exclusive processors". but exempts non-exclusive processors.[4]

In sum, the SEC need not and should not oversee market data fees of registered exchanges (or of ECNs, conventional broker-dealers, vendors and others acting as information processors) where they are not the exclusive source of the data; that is, where competitive conditions prevail. Thus, we suggest as a first condition to SEC fee oversight of limit orders:

> The registered exchange must be the *exclusive* source of the data.

Core Functionality: Even in a competitive, non-exclusive environment – as exists today among registered exchanges in offering execution services – Congress plainly intended direct SEC oversight of at least some activities of registered exchanges. While the Committee did not explicitly examine the public policy bases for defining the boundaries of this oversight, as Rick points out, the SEC recently attempted such a definition.

The SEC's definition came in the context of exempting NASDAQ from section 19(b)'s requirements for SEC review of rule and fee changes as to the activities of a software development subsidiary, Financial Systemware, Inc. ("FSI").[5] In granting the exemption, the SEC imposed several conditions to assure that the subsidiary's activities were sufficiently separate from what Rick calls the "core functionality" of NASDAQ. The

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[3]We are not arguing here for any diminution of the SEC's oversight of a registered exchange's compliance with the governance requirements of section 6: an exchange's rules must "assure fair representation of its members in the selection of its directors and administration of its affairs and provide for … representati[on] of issuers and investors" and, in particular, must "provide for the equitable allocation of reasonable … fees … among its members and issuers and other persons using its facilities". (1934 Act sections 6(b)(3) and (4).)

[4] Section 11A(b)(1). This section does delegate to the SEC authority to remove the exemption if it finds that the public interest requires registration.

[5] Release No. 34-44201 (April 18, 2001).

underlying concept is that direct SEC oversight of the activity of a registered exchange should be limited to the exchange's core functions: the SEC should directly oversee those activities of a registered exchange – and only those activities – that require the exchange's registration.

As to limit order data, we can restate this concept as a second condition to SEC fee oversight:

> The data must derive from the *core functionality* of the registered exchange.

Below, we demonstrate that, unlike quotes and prices, limit order data meet neither the exclusivity condition nor the core functionality condition for direct SEC oversight of exchange fees.

Are Limit Order Data Exclusive to Registered Exchanges?

When a limit order sent to the Exchange interacts with other limit orders, with trading floor interest, with other agency orders entrusted to the specialist or with the proprietary interest of the specialist, the interaction generates quotes and last sale prices – information exclusively available from the Exchange. The quotes and prices (and executions) are the finished products of the Exchange's auction – the *outputs*. But the limit orders themselves are the raw materials for the auction – the *inputs*. Although the Exchange collects limit orders from its member organizations and processes them (i.e., it validates, safe stores, arrays and displays them), it does not produce them. By definition, it is not the exclusive source.

The discussion at the Langevoort Subcommittee underscored that, in disseminating limit orders, registered exchanges face existing and potential competition from a variety of domestic and foreign competitors that are not registered as exchanges, including non-US exchanges, ECNs, conventional broker-dealers, internet portals, conventional information vendors and others. For example, today, several ECNs pool their customers' limit orders on an internet portal in addition to displaying them on their own systems (and making them available for execution there).

Thus, since a registered exchange is not the exclusive source for a particular limit order, limit order data do not meet the "exclusivity" condition.

Prior to Interaction, Are Limit Orders Part of an Exchange's "Core Functionality"?

Limit orders both convey information and serve as execution inputs. Non-US exchanges, ECNs, conventional broker-dealers, internet portals, conventional information vendors and others, as well as registered exchanges, array limit orders in various formats to convey their information content.

As execution inputs, limit orders compete with each other and with other trading interest for execution. As they enter the auction, they become subject to systemic and "rule book" rules governing their "standing" in the auction – determining, for example, whether they have priority, parity or precedence in the auction. In the parlance of the FSI exemption, upon interaction, limit orders cross into the "core functionality" of a registered exchange.[6]

But as information, they stand outside the core.[7]

Thus, it seems to us that, as information content, limit order data also do not meet the second, "core functionality", condition.

<u>Information Filings?</u>

Although limit order data meet neither the exclusivity condition nor the core functionality condition for direct SEC oversight, the SEC may still need to monitor a registered exchange's limit order information services. When a regulated entity engages in non-regulated activities, whether directly or through affiliates, its regulator may need to monitor the relationship between the regulated entity/activities and the unregulated entity/activities. So, for example, while the Exchange has no direct jurisdiction over the activities conducted by non-member affiliates of a member organization, it does monitor fund flows between the member organization and its affiliates.[8]

Here also the FSI exemption instructs us. The conditions of the exemption seek to assure meaningful separation of the subsidiary's peripheral activities from NASDAQ's core functionality. This assures that the SEC's regulation of NASDAQ's core functionality is not implicated.

The separation issue is acute in the case of FSI because its products enhance NASDAQ's workstation software; i.e., the products potentially gate NASDAQ's execution services. But the underlying concern is relevant even in the less acute case of the limit order information services of a registered exchange or its affiliates. The SEC must have confidence that a registered exchange's conduct of non-exclusive, non-core functions does not undermine or

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[6] From a market structure perspective, we are distinguishing between (1) order "fission" in the auction (core functionality) and (2) how the display or removal from the display, of a limit order may cause a broker-dealer (either manually or with automated assistance) to enter or cancel other limit orders. From the parallel systems perspective, we are distinguishing between (1) quote composition, quote display, order execution, trade reporting and post-trade (core functionality), and (2) limit order validation, safe storing, array and display.

[7] A limit order's dual manifestation as both information and execution input has an analog in the exchange's outputs, where execution yields both a last sale price and a trade.

[8] Famously, our monitoring enabled the SEC and the Exchange to prevent Drexel from withdrawing capital from its member organization on the eve of the holding group's bankruptcy.

"end-run" the SEC's regulation of the exchange's core trade execution, exclusive processor, post-trade and market surveillance functions.[9]

For this reason, we believe that registered exchanges should file on a confidential basis notice of their and their affiliates' enhanced data offerings to permit the SEC to assess for itself whether those offerings implicate the registered exchange's core functionality sufficiently to require intervention. We note that, as the keystone to the SEC's automation review policy and Regulation ATS, confidential information filings have a proven track record.

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We greatly appreciate Rick's effort to help the Committee articulate a conceptual approach to determining whether the SEC needs to oversee fees for enhanced data and commercial products and services. However, we believe his different treatment of these two tiers proves untenable upon closer examination, since neither tier comprises data available exclusively from a registered exchange or implicates core functionality. Thus, we believe that a registered exchange's pricing of enhanced data, as well as of commercial products and services, should be subject neither to SEC pre-approval nor to SEC abrogation.

Sincerely yours,

Robert G. Britz

cc: Annette Nazareth
      David Shillman
      Anitra Cassas
     Members of the SEC Advisory Committee on Market Information

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[9] Although less likely to be implicated by enhanced data offerings, we note that other section 6 matters – access, membership, governance, upstairs regulation and enforcement – also lie at the "core" of a registered exchange.