



Regulatory Update — SEC Revises its Market Structure Proposals

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Summary of Re-Proposed Regulation NMS¹

At an open meeting on December 15, 2004, the Securities and Exchange Commission, by a 4-1 vote, approved publication of a revised version of proposed Regulation NMS.² According to the Commission, re-proposed Regulation NMS is a response to the more than 700 comment letters and hearing testimony addressing Commission's original and supplemental proposals for Regulation NMS. Focusing on the most significant provisions of proposed Regulation NMS, this memo will primarily describe the differences between the Commission's new proposals and the prior iterations of these proposals. The comment period for the new proposals is particularly short — only 30 days from publication of the release in the Federal Register — and comments are due by January 26, 2005.

I. Revised Trade-Through Proposal

As now re-proposed, Rule 611 of Regulation NMS ("Order Protection Rule") would establish market-wide price protection for automated quotations in any NMS stock that are immediately accessible. Under this proposal, "trading centers"³ must establish, maintain and enforce written policies and procedures that are reasonably designed to prevent trade-throughs of protected quotations, and if relying on an exception, that are reasonably designed to assure compliance with that exception. These protections only extend to "automated" quotations — those that are displayed and immediately accessible through automatic execution (*i.e.*, an incoming order can receive an immediate execution up to full size of the quote without human intervention). This rule contains a number of exceptions that are discussed below, including an exception from having to route orders to a trading center that demonstrates a pattern of at least one-second delays in responding to orders sent to it (*i.e.*, "material delays").

¹ This publication has been prepared for general information of clients and friends of the firm as a brief description of recent SEC action. It is not meant to provide legal advice with respect to any specific matter.

² See Exchange Act Release No. 50870 (Dec. 16, 2004), 69 FR 77424 (Dec. 27, 2004) (the "Re-proposing Release"), which is available on the Commission's Web site at: <http://www.sec.gov/rules/proposed/34-50870.pdf>.

³ A "trading center" is defined as any national securities exchange or national securities association that operates an SRO trading facility, ATS, exchange market maker (*i.e.*, exchange specialist), OTC market maker, or "any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent" (*e.g.*, a block positioner).

A trading center displaying an automated quote must provide an "immediate-or-cancel" ("IOC") functionality for an incoming order to execute immediately and automatically against the quote up to its full size, and for any unexecuted portion of such incoming order to be cancelled immediately and automatically without being routed elsewhere. A customer can choose how its order will be handled by the trading center displaying an automated quote, however — if a customer does not designate his order as an IOC order, he gives the trading center permission to take further action on the order (*e.g.*, route the order elsewhere or display it). Trading centers also would be required to immediately and automatically update their automated quotations to reflect any change to their material terms (*i.e.*, change in price, size or "automated" status of quotes).

In order to facilitate hybrid trading systems that combine automated and manual quotes and executions, the Commission will permit a hybrid market to display both automated and manual quotes, but only when that market meets basic standards of fair and efficient access by the public to the market's automated quotations. If the market does not meet those standards, none of its quotations could qualify as automated quotations. To be an automated trading center, the trading center must have implemented such systems and rules as are necessary to render it capable of displaying quotations that meet the access, response and updating requirements of an "automated quotation." The trading center also must identify all quotations other than automated quotations as manual quotations, and immediately identify its quotes as manual whenever it has reason to believe that it is not capable of displaying automated quotations. Furthermore, it must adopt reasonable standards limiting when its quotations change from automated quotes to manual quotes, and vice-versa, to specifically defined circumstances that promote fair and efficient access to its automated quotations and are consistent with the maintenance of fair and orderly markets.⁴

The Commission has proposed two alternatives regarding the scope of the Trade-Through Rule — price protection could be limited to top-of-book (the "Market BBO Alternative") or it could extend to the displayed depth-of-book ("DOB") if the market center voluntarily displayed

⁴ This requirement is intended to assure that hybrid markets do not give their members, or anyone else, overbroad discretion to control the automated or manual status of the trading center's quotations to the detriment of less favorably situated market participants. According to the Commission, for a trading center to be able to display any protected quotes, the public in general must have fair and efficient access to a trading center's quotes. See 69 FR at 77436.

such depth (the “Voluntary Depth Alternative”). Under the Market BBO Alternative, a protected bid or offer would be a quotation in an NMS stock that (i) is displayed by an automated trading center, (ii) is disseminated pursuant to an effective national market system plan, and (iii) is an automated quotation that is the best bid or best offer of a national securities exchange, Nasdaq, or a national securities association other than the best bid or best offer of Nasdaq (*i.e.*, the ADF).

Under the Voluntary Depth Alternative, in addition to all of the quotations under the Market BBO Alternative, any additional bids or offers that are designated as protected bids or protected offers pursuant to an effective national market system plan also would be protected from trade-throughs. To comply with the Voluntary Depth Alternative, trading centers would have to monitor many more protected quotations displayed by other markets and route orders to execute against such quotes.⁵ Furthermore, DOB quotes could not be protected unless market participants have access to information as to which quotes were protected, such quote information is made available on fair and reasonable terms, and market participants have fair and efficient access to the protected quotes at a reasonable cost.

Although a trading center would be able to choose whether all of its quotes would be subject to protection under the DOB alternative, it is likely that once one trading center sought DOB trade-through protection, the other trading centers would soon follow. Arguably, this would move the market one major step closer to the establishment of a Central Limit Order Book-like facility, except that there would be no time priority, only universal price priority. Moreover, the Voluntary Depth Alternative would require a massive amount of systems programming across market centers. It is unclear from the release whether the SEC appreciates the enormity of such changes.⁶

⁵ According to the Commission, the Voluntary Depth Alternative would not increase the number of orders a trading center would be required to route to other markets before executing a trade in its own market in order to avoid violating the Trade-Through Rule under the Market BBO Alternative, but it would increase the size of those orders because they would have to reflect the accumulated size of all protected orders at each of the other markets.

⁶ Also, in what appears to have been an inadvertent disclosure on the Commission’s part in the Re-proposing Release, the Commission indicated that it intends the effective date of an adopted Regulation NMS to be November 5, 2005. See Re-proposing Release, 69 FR at 77459. If this is truly the Commission’s intent, this deadline would be near impossible to meet, considering the massive overhauls of electronic systems in every sector of the industry that would be required for compliance with the myriad proposed requirements of Regulation NMS, many of which will have to follow directly on the heels of the complicated

There are numerous proposed exceptions to the re-proposed Trade-Through Rule, including an intermarket sweep exception, which will allow market participants simultaneously to access multiple price levels at different trade centers and is designed to address the execution of larger-sized orders.⁷ Significantly, as re-proposed, the rule would not contain a broad block trade exception, but only this narrower sweep exception for block trades after the block trade has interacted with better-priced book orders. Other exceptions include those for: (1) quotations of a market center experiencing, among other things, a material delay in providing a response to incoming orders;⁸ (2) flickering quotes that have been displayed for less than one second;⁹ (3) VWAP and other “benchmark”-priced orders; (4) orders for other than “regular way” contracts; (5) single-price opening, reopening, or closing transactions; and (6) transactions executed at a time when protected quotations were crossed (but not when the protected quotes were merely locked).

As re-proposed, however, the Trade-Through Rule will have no opt out provision from the trade-through

systems changes mandated by recently-adopted Regulation SHO and the related Pilot program.

⁷ There are actually two exceptions related to intermarket sweep orders — one for when the transaction that constituted the trade-through was the execution of an order identified as an intermarket sweep order, and the other for when the transaction that constituted the trade-through was effected by a trading center that simultaneously routed an intermarket sweep order to execute against the full displayed size of any protected quotation in the NMS stock that was traded through.

⁸ The earlier proposal also had contained an exception for transactions by a trading center experiencing systems problems (which is the other side of this exception, which applies when the market being traded through is experiencing “material delays” in response times). The Commission implies that a trading center’s isolated, and unavoidable, trade throughs due to systems problems may not violate the Rule, see 69 FR at 77447, n. 151, but that if a trading center effects transactions that trade through protected quotes of other trading centers because of systems problems on a recurring basis, its policies and procedures might not be “reasonable” in violation of the Trade Through Rule.

⁹ This exception, which is in re-proposed Rule 611(b)(8), would allow a trading center to trade at any price equal to or better than the least aggressive best bid or best offer, as applicable, displayed by the other trading center during the one-second “window” prior to the transaction. Thus, if another trading center’s displayed best bid is flickering between \$10.50 and \$10.51, a trading center could execute a trade in its own market at \$10.50 without violating the Trade Through Rule. That trading centers may be given a one-second “look back” for flickering quotes, however, raises the question as to whether a trading center should be required to recognize, for purposes of the Trade Through Rule, any displayed quote of any other trading center that has not been displayed for at least a full second prior to executing a trade in its own market at a different price.

protections. In the Commission's view, the limitation of trade-through protections only to immediately accessible quotations that are available for automatic execution and the addition of various exceptions to the Rule's protections would provide a good substitute for the prior opt-out proposal.

II. Revised Access Proposal

As now proposed, Rule 610 of Regulation NMS ("Access Rule") would promote fair and non-discriminatory access to quotations through a private access approach and establish a limit on access fees to harmonize the pricing of quotations across different trading centers. Specifically, Rule 610(a) would prohibit SROs from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member of the SRO to the quotations in an NMS stock displayed through its SRO trading facility. For instance, an SRO could not charge discriminatory fees to competitors accessing its quotes, but an SRO could charge its members other types of differential fees, such as volume-based discounts or fees that are reasonably related to the cost of providing the particular service, as long as those fees did not vary based on the non-member status of the person obtaining indirect access to the quotes through the member.

Despite comments urging the contrary, the Commission has preliminarily determined not to require small market centers to make their quotations accessible through an SRO trading facility. Instead, it has re-proposed Rule 610(b)(1), which requires any trading center that displays quotations in an NMS stock through an SRO display-only facility [*i.e.*, the ADF] to provide a level and cost of access to such quotations that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities in that stock. The Rule also precludes those trading centers from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access to such quotations through a member, subscriber, or customer of the trading center. Thus, ATSs and market makers that choose to display quotations in NMS stocks in the Nasdaq ADF must bear the responsibility of establishing the necessary connections to afford the same level of fair and efficient access to their quotes as required for access to quotes displayed by SRO trading facilities. Furthermore, any such trading center that displays quotes through the ADF will be prohibited from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access to those quotes through a member, subscriber or customer of the trading center.

In addition, the Commission has proposed to raise the access fee cap from \$0.002 to \$0.003 per share for protected quotes (*i.e.*, those subject to trade through protection) of \$1.00 or more, and would cap accumulated fees at 0.3% of the quotation price per share for protected quotes with prices of less than \$1.00. The fee caps contemplated under this rule would apply only to those quotations that are protected by the Trade-Through Rule, would encompass any fees based on the execution of an order against a protected quotation (including access fees charged by ECNs and transaction fees charged by SROs), and encompass both fees charged by a trading center and fees charged by market participants displaying quotes through the trading center's facilities. Under the rule, market makers, who are now precluded by the Quote Rule from charging access fees, would be permitted to charge fees for access to their quotes, whether through an SRO trading facility or directly, as long as the fees meet the rule's requirements.

SROs also will be required to establish and enforce rules that (i) require their members to avoid displaying quotations that lock or cross any protected quotation in an NMS stock, and to avoid displaying manual quotations that lock or cross any quote in an NMS stock disseminated pursuant to an effective national market system plan; (ii) are reasonably designed to assure the reconciliation of locked or crossed quotations in an NMS stock; and (iii) prohibit members from engaging in a pattern or practice of displaying quotations that lock or cross any protected quote in any NMS stock, or of displaying manual quotes that lock or cross any quotes in an NMS stock disseminated pursuant to an effective national market system plan. Essentially, this means that automated quotes protected under the Trade-Through Rule may not be crossed or locked by any other quotes, whether automated or manual, and manual quotes may not lock or cross any other quotes (except accidentally on an occasional basis). There is no proscription, however, against automated quotes locking or crossing manual quotes.

The Commission also has re-proposed its amendment to Regulation ATS to lower the threshold that triggers the Regulation ATS fair access requirements from 20% to 5% of the average daily trading volume in a security. Under this amendment, if an ATS is required to display its quotations under Regulation ATS because it meets the 5% threshold, it will be required to provide fair access to those quotations under the Access Rule as well.

III. Revised Subpenny Proposal

Rule 612 of Regulation NMS (“Sub-Penny Rule”) would prohibit bids, offers, orders, and indications of interest equal to or greater than \$1.00 in an increment smaller than \$0.01. As re-proposed, the rule keys off of the price of the quotation, not the price of the stock as the prior proposal did, which should, in the Commission’s view, spare market participants from having to track the current price, and therefore eligibility, of those stocks whose market price is near the \$1.00 mark. Under this rule, a market participant could not accept an order in an NMS stock priced at \$1.0010, even if the stock were trading below \$1.00. In addition, the new rule limits quotes priced at less than \$1.00 to four decimal places. While the original rule would have wholly exempted securities priced at less than \$1.00 from the prohibitions against sub-penny quoting, the new rule would prohibit bids, offers, orders, and indications of interest priced less than \$1.00 in an increment smaller than \$0.0001. Thus, a market participant could accept an order priced at \$0.8585, but not an order priced at \$0.85849. Likewise, a market participant could not post a bid for \$1.0001, although it could post a bid of \$0.9999.

Like the prior rule, the new rule does not prohibit sub-penny trading, whether that is the result of mid-point or VWAP algorithms or of broker-dealers offering sub-penny price improvement. The proposed rule continues to prohibit exchanges, the NASD, ATSS, vendors, or broker-dealers from accepting sub-penny quotes, even if they consistently re-price such quotes to an acceptable increment (*i.e.*, rounding prices) to preclude investor confusion.

The Commission also noted that the prior proposal included a provision that would establish procedures for the Commission to grant exemptions to the rule, and the re-proposed rule continues to provide the Commission with exemptive authority. In connection with the original proposal, the Commission had sought comment on whether certain securities, specifically including ETFs like QQQ,¹⁰ should be exempted from the prohibition against sub-penny quoting. In the Re-proposing Release, the Commission stated its belief that “a basis likely may exist to grant an exemption from the sub-penny quoting prohibition for QQQQ and perhaps other actively traded ETFs,” such that the NASD or any exchange, ATS, vendor, or broker-dealer could display, rank or accept from any person a bid or offer, order or indication of interest in such ETFs in increments less than \$0.01. (Because the minimum price

variation for stocks on SROs is generally limited to at least \$0.01, exempting ETFs from the sub-penny quoting prohibition will effectively make permanent the two-tiered market that currently exists for such ETFs between SROs, that do not permit sub-penny quoting now, and ECNs and ATSS, which regularly display sub-penny quotes.) The Commission also continues to believe that this rule should not apply to the quoting of options.

IV. Revised Market Data Proposal

Amendments to Rules 11Aa3-1 and 11Ac1-2 under the Securities Exchange Act of 1934 (“Exchange Act”) (re-designated as Rule 601 and 603 of Regulation NMS) (“Market Data Rules”) would update the requirements for consolidating, distributing, and displaying market information. Despite some commenters’ views favoring a multiple consolidator model (*i.e.*, each SRO and Nasdaq would establish its own fees, enter into and administer its own market data contracts, and provide its own data distribution facility through which data vendors and broker-dealers could purchase data, consolidate it and distribute it to end users) and Nasdaq’s urging of a hybrid model (*i.e.*, quotes representing the NBBO would be consolidated, but all trade reports and quotes other than the NBBO would be deconsolidated), the Commission has determined to keep the current consolidation model for market data dissemination. In response to concerns about the level of fees for market data, the Commission indicated that it intends to review market data fees in connection with overall SRO revenues and funding of self-regulation, and has begun such a review in connection with its recently-issued concept release relating to SRO structure. As it considers the broader issues, however, the Commission intends to reform the current revenue allocation formulas under the various Joint Industry Plans.

A. Revenue Allocation

Specifically, the Commission is proposing to simplify the market data formula originally proposed in Regulation NMS. The new formula involves a two-step process: (1) a Network’s distributable revenues would be allocated among the many individual securities including in the Network’s data stream; and (2) the revenues that are allocated to an individual security then would be allocated among the SROs based on measures of the usefulness to investors of their trades and quotes in the security. Under the new proposed formula, SRO participants in a Plan would receive an annual payment for each calendar year that is equal to the sum of the SRO’s Trading Shares and the Quoting Shares in each Network security for the year.

¹⁰ The Nasdaq-100 Index Tracking Stock as listed on Nasdaq trades under the symbol “QQQQ” but the ETF is generally and commonly known as “QQQ.”

While the prior proposed allocation formula would have calculated an SRO's Trading Share on the basis of qualified trade reports having a dollar volume of \$5000 or more, the new proposal also would award a fractional proportion of a qualified trade of less than \$5000 (*e.g.*, a \$2500 trade would constitute 1/2 of a qualified report). The re-proposed formula continues to contain a square root function to adjust for the highly disproportionate level of trading in the top tier of Network stocks with the highest volumes, and to reward markets for providing price discovery in less active stocks.

With respect to Quoting Shares, allocations would be based on the extent to which an SRO's quotes equal the NBBO. Only automated and fully accessible quotations would be entitled to earn a share of market data revenues; manual quotes would earn none. Furthermore, quotations would earn significant revenues only if they represent a significant proportion of the total size of quotations displayed at the NBBO for a stock throughout the trading year.

B. Distribution and Display of Market Data

The Commission is re-proposing Rule 603(a) as proposed. Although the various Plans would continue to call for the trades and best quotes (*i.e.*, price, size and market center identifications of the NBBO and the most recent last sale information) in exchange-listed and Nasdaq-listed stocks to be made available on a real-time and consolidated basis, this rule would authorize the independent distribution of additional data by individual market centers. In this regard, each market center will be required to make its NBBO available for regulatory surveillance purposes, but the rest of its quote data, such as limit order books, could be sold for distribution. Independently distributed data, however, may not be made available on a more timely basis than core data is made available to a Network processor.

C. Plan Governance

The Commission also has re-proposed an amendment to the Joint Industry Plans for disseminating market information that would broaden participation in Plan governance by requiring the creation of non-voting advisory committees ("Governance Amendment"). Members of these committees will have the right to submit their views to the Plan operating committees on Plan matters, including any new or modified product, fee, contract, or pilot program. In spite of commenters' urging for even more participation in the Plans by non-SRO parties, the Commission views its proposal as a "useful first step toward improving the responsiveness of Plan participants and the efficiency of Plan operations."

For Further Information

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