Response of The Nasdaq Stock Market to Agenda for March 1 Meeting of the SEC Advisory Committee on Market Information

Nasdaq submits the following responses to the alternative recommendations set forth in the Agenda for the March 1, 2001 meeting of the SEC Advisory Committee on Market Information ("Advisory Committee"). These responses are based on Dean Seligman's request that, for purposes of the March 1st meeting, the Advisory Committee focus on improvements to the existing model for consolidating and disseminating market information. As discussed in Nasdaq's Submission to the SEC Advisory Committee on Market Information ("white paper"), Nasdaq's strong preference is for the Advisory Committee to recommend a more fundamental change in the way market information is consolidated and disseminated. Nonetheless, our responses below, unless otherwise noted, assume a more incremental approach that refines the existing model.

I. Market Information that Vendors and Broker-Dealers Should be Required to Provide to Customers

Nasdaq believes that it is imperative to retain the requirements of the Vendor Display Rule (Rule 11Ac1-2). The Vendor Display Rule requires a vendor or broker-dealer that is providing quotation information with respect to a particular subject security to include either the NBBO, or a quotation montage for the security from all reporting market centers. If transaction reports or last-sale data are provided with respect to a particular reported security, the vendor or broker-dealer must include the price and volume of the most recently reported transaction, and an identification of the market center in which such transaction took place. Even in a decimal trading environment, the NBBO is among the most vital pieces of market information available to market participants, including exchanges, broker-dealers, and institutional and retail investors. A reliable and widely disseminated NBBO ensures that customers are informed of the best prices and sizes available in the various market centers.

Moreover, the NBBO is critical in assisting broker-dealers in meeting their best execution obligation, as well as complying with various rules and regulations. For example, without accurate last sale and NBBO information, complying with the applicable short sale rule is a futile exercise. Indeed, as recently noted by SEC Commissioner Paul R. Carey, "the inability to discover the best prices in the national market would be a major step backward."[1]

II. How Market Information Should Be Consolidated

Nasdaq believes that the consolidation or processing function should be performed by an entity that is either independent of any NMS plan participant or is jointly operated by the plan participants. Additionally, any processor should be selected through a competitive bidding process. If a satisfactory bidder does not emerge from the selection process, the NMS plan participants would then consider alternative means of identifying an appropriate entity to serve as the plan's processor.

As discussed in the white paper, with respect to Nasdaq-listed securities, Nasdaq envisions competing processors as the optimal SIP structure. However, Nasdaq does discuss an interim solution of a single consolidator that performs a quasi public utility function by consolidating the best bid and offer ("BBO") and last sale information (and ***only*** the BBO and last sale information) received from each of the NMS plan participants. The independent consolidator would be chosen by soliciting bids from any number of independent, reputable firms and selecting the consolidator based on cost, reliability and reputation. Only firms that are able to demonstrate that they have the necessary technical capability and resources would be considered. The Operating Committee of each NMS plan would be responsible for selecting the independent processor based on these criteria.

III. Governance of the Consolidators

Nasdaq believes that non-SRO entities such as ECNs, ATSs, market makers, specialists, other broker-dealers, investors and market data vendors should have a voice in the operation of any NMS plan. Section 11A(a)(3)(B) of the Exchange Act, however, clearly contemplates that only SROs should participate directly in the governance of an NMS plan. As addressed in the white paper, there are several compelling policy reasons why direct NMS plan governance should continue to be limited to SROs. Nonetheless, an advisory committee for each NMS plan, comprised of appropriate non-SRO representatives, would provide these constituencies with a vehicle to express their views on all aspects of NMS plan governance. A representative from the advisory committee should be able to attend the

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[1] *See* "Market Information: Searching for Consensus," SEC Commissioner Paul R. Carey, Twenty-Eighth Annual Securities Regulation Institute, January 25, 2001.

Operating Committee meetings to discuss Plan issues and voice the opinion(s) of the advisory committee. Comments submitted by the advisory committee would be reflected in any subsequent public filings or notices submitted to the SEC.

IV. How User Fees are Determined and Revenues Allocated Among Plan Participants

Like today, user fees would continue to be negotiated with vendors, broker-dealers, and other users. In addition, any proposed fee change imposed by the associated NMS plan of the processor, of course, would be required to be filed with the SEC and would be subject to public notice and comment procedures. In Nasdaq's preferred market choice alternative, the Boards of each exchange, comprised of a cross-section of the exchange's constituents, would play an increased role in keeping user fees in check.

With respect to plan revenues, Nasdaq believes that the market responsible for the execution of a particular security transaction should be credited with a corresponding allocation of the revenue from the associated NMS plan. Moreover, Nasdaq believes that its current method of sharing revenues (*i.e.*, based on an average of the percentage of total transaction volume and the percentage of total share volume) is preferable to any other methodology, particularly any methodology based on quoting activity.[2] As noted in the Agenda for the March 1st meeting, the Advisory Committee's recommendations in this area will apply only to market information that is required to be provided to customers (*i.e.*, NBBO and last sale information). In this regard, Nasdaq has proposed in its "single consolidator" alternative that quotation information from each plan participant, other than last sale and BBO information, would not be subject to the NMS plan. Accordingly, revenue sharing calculations for quotation information in respect of NMS plan participants would be based exclusively on each participant's respective BBO information. This methodology encourages competing markets to seek out increased order flow to their respective markets through robust competition, and revenues would be allocated in direct proportion to the true economic value that each market provides in relation to the aggregate data stream.

In the single consolidator alternative, costs associated with establishing and maintaining the processor should be allocated equally among all exchange participants in the associated NMS plan. Alternatively, once the processor is established, plan participants could consider allocating costs among exchange participants in proportion to their respective share of revenue, assuming that revenue sharing is based on the Nasdaq revenue allocation methodology (or a similar methodology that rewards market

[2] A methodology of revenue sharing that is based on quote activity is likely to create inequities because of the potential for manipulation of quotations to generate revenue through the plan. *See* Letter from Annette Nazareth, SEC, to The Honorable John Dingell, dated December 21, 2000, available at http://www.house.gov/commerce_democrats/press/secspoofing.pdf (responding to request by Congressman Dingell to Chairman Levitt for information on the entry of "phantom quotes" by market makers).

centers for the *value* of their information). The latter alternative would be conditioned on each plan participant sharing equitably the fixed and administrative costs. In addition, the participants would have to establish a buy-in provision for setting up the processor, under which applicable expenses are shared equally across all plan participants, with a continued buy-in for new entrants to be shared equally among all existing participants. The cost associated with the establishment of the processor will be substantial, and unless each plan participant shares equally, there will not be a shared incentive to keep costs reasonable and the processor efficient.

V. Ancillary Matters -- Technological Issues

Nasdaq believes that the best way to promote technological innovation is to provide incentives for entities performing the role of processor. This would be best achieved by a model for collecting and disseminating market information that permits each SRO to contract separately with any number of market data vendors that would perform the consolidation function. Nasdaq has made clear its strong preference for this type of approach in recommending the market choice alternative in its white paper. In this regard, Nasdaq believes that competition will breed innovation.

Nonetheless, assuming the continued existence of NMS plans under an approach that would improve the existing model, Nasdaq's single consolidator alternative would provide incentives for the processor to pursue technological improvements. For example, contractual arrangements between the NMS plans and their respective processors could be structured so as to provide economic incentives to the processor for pursuing technological improvements, assuming the processor is an independent entity under contract to the Plan.