

Potential Ramifications of The Exchange Regulatory Improvement Act (H.R. 3555)

On July 28, 2017, Representative Barry Loudermilk (R) and others¹ introduced the Exchange Regulatory Improvement Act (“H.R. 3555”) in order to “modernize the Securities Exchange Act” and “put guardrails on the agencies to prevent overregulation.”² The sponsors aim to accomplish these goals by modifying the definition of “facility” under the Securities Exchange Act of 1934 (the “Exchange Act”), which has been in place since 1934, to narrow the scope of premises, property, rights and services that would be “facilities” of national securities exchanges and thereby narrow the regulatory authority of the Securities and Exchange Commission (the “SEC”).³

Proponents of the existing definition of “facilities” note that it is vital to the SEC’s ability to effectively regulate the national securities markets in the face of changing technologies and business models. They believe that narrowing the definition to curtail the SEC’s regulatory authority over the exchanges could prevent the SEC from ensuring the equitable operation of the markets by allowing the exchanges to utilize their market positions to the detriment of other market participants and transparency, cooperation and competition generally. They have expressed serious concerns that, at a minimum, H.R. 3555 is likely to result in prolonged litigation with respect to the scope of the SEC’s authority to regulate the exchanges in a number of areas, during which time the costs of uncertainty will be borne by market participants and the investing public, and, at worst, H.R. 3555 could have unintended consequences that are damaging to the markets and investor trust in federal regulation of the national market system.

This paper summarizes the regulatory scheme that would be altered by an amendment to the Exchange Act such as that proposed in H.R. 3555 and discusses the potential consequences should such an amendment become law.

Exchange Regulation

Understanding the potential impact of H.R. 3555 is dependent on an understanding of the regulatory landscape with respect to the national securities exchanges and the national securities market. Prior to the passage of the Exchange Act, the exchanges were purely self-regulatory, overseeing their members without governmental oversight. Congress enacted the Exchange Act in 1934, rejecting the arguments put forth by the exchanges that they could sufficiently protect investors solely by regulating themselves.⁴ The Exchange Act established a regulatory scheme under which the national securities exchanges are both regulated by the SEC and have been formally delegated powers to supervise their members as self-regulatory organizations (“SROs”).

¹ H.R. 3555 was co-sponsored by Congressmen Greg Meeks (D) and Lee Zeldin (R) of New York, David Scott (D) and Barry Loudermilk (R) of Georgia, and Randy Hultgren (R) of Illinois.

² Press release of Representative Loudermilk dated August 11, 2017 (<https://loudermilk.house.gov/news/documentsingle.aspx?DocumentID=1167>).

³ Exchange Regulatory Improvement Act, H.R. 3555, 115th Cong. (2017-2018).

⁴ See S. Rep No. 792, 73d Cong., 2d Sess., 4 (1934).

Under the Exchange Act, in order to register as a national securities exchange and be in position to perform its function as an SRO enforcing compliance by its members, the rules of an exchange, among other things, must be designed to:

- prevent fraudulent and manipulative acts and practices;
- promote just and equitable principles of trade;
- foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities;
- remove impediments to and perfect the mechanism of a free and open market and a national market system”; and
- in general, . . . protect investors and the public interest.”⁵

These principles, embodied in the Exchange Act since 1934 with respect to the rules of the national securities exchanges, remained a focus in connection with the creation and regulation of the national market system. In 1975, Congress amended the Exchange Act to expand the SEC’s oversight with respect to national securities exchanges in order to facilitate the establishment of a national market system for securities (the “1975 Amendments”).⁶ In doing so, Congress focused on eliminating barriers to communication and competition, noting that the 1975 Amendments were designed to ensure that the national market system maximized the “opportunity for the most willing seller to meet the most willing buyer” and that the market structure at that time did not afford such opportunity due in part to “unjustified barriers to access to markets and market makers, opposition to market integration from powerful vested interests, monopoly control of essential mechanisms for the dissemination of market information, and the absence of effective control of market developments and operations by the SEC.”⁷

As part of a limited group of national securities exchanges registered with the SEC, the SROs are the sole initial recipients of market data that their members are required to provide. Each SRO can use that data to obtain a picture of the market on its exchange. Market participants, including the broker-dealers that provided portions of the underlying data, must obtain the data from the national exchange or from another source that obtains it from them. A market participant seeking a picture of the whole market needs to obtain the data from each national exchange.⁸ Recognizing the concentration of control over critical market components by the national securities exchanges, Congress intended that the SEC “police effectively the new national market system”⁹ and set forth goals for the system in new Section 11A of the Exchange

⁵ See Exchange Act Section 6(b)(1), 15 U.S.C. 78f(b)(5).

⁶ See Exchange Act Section 11(a)(2), 15 U.S.C. 78k-1(a)(2).

⁷ H.R. Rep No. 94-123, 94th Cong., 1st Sess., 50 (1975). See also S. Rep No. 93-13, 93d Cong., 1st Sess., 96 (1973).

⁸ See, e.g., U.S. Department of the Treasury, *A Financial System that Creates Economic Opportunities: Capital Markets* (October 2017), noting that “For use in making routing and trading decisions for active or institutional size order flow, data from one exchange’s feed cannot substitute for data from another exchange’s feed.” *Id.* at 63.

⁹ S. Rep No. 94-75, 94th Cong., 2nd Sess., 2 (1975).

Act:

- fair competition among brokers and dealers, among exchange markets, and between exchanges and other marketplaces;
- economically efficient executions of securities transactions;
- availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
- opportunities for best trade execution; and
- the opportunity for the execution of customer orders without dealer intervention.¹⁰

Focusing particularly on the availability of critical information to market participants, the regulatory scheme established in 1975 provided the SEC the authority to regulate and implement national communications systems for sale report and quotation information in order “to insure the availability of prompt and accurate trading information, to assure that these communication networks are not controlled or dominated by any particular market center, to guarantee fair access to such systems by all brokers, dealers and investors, and to prevent any competitive restriction on their operation not justified by purposes of the Exchange Act.”¹¹

As part of the 1975 Amendments, Congress also augmented the SEC’s power to review and approve any changes to the rules of the national securities exchanges. Some rule changes proposed by the SROs do not take effect until the SEC approves them, while others take immediate effect subject to the SEC’s authority to suspend the effectiveness of the changes and institute proceedings to approve or disapprove them.¹² The Exchange Act also gives the SEC the authority to enforce compliance with the rules by the national securities exchanges through censure, the imposition of limitations or further requirements on the exchanges, and the potential suspension or revocation of an exchange’s registration.¹³ Since the 1975 Amendments, the SEC has undertaken numerous rulemakings intended to improve the national securities market, including attempts to increase the efficiency and transparency of the market.

Facilities of an Exchange

“Facilities” under the Exchange Act

The term “facility” is defined broadly in Section 3(a)(2) of the Exchange Act to include, when used with respect to an exchange:

its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of

¹⁰ Exchange Act Section 11A(a)(1)(C), 15 U.S.C. 78k-1.

¹¹ S. Rep No. 94-75, 94th Cong., 1st Sess., 9 (1975).

¹² See 15 U.S.C 78s(b)(1)-(3) and 17 C.F.R. 240.19b-4(f).

¹³ See 15 U.S.C 78(h)(1) and 78u-3.

the exchange to the use of any property or service.¹⁴

The term “facility” with respect to a national securities exchange appears 20 times in the Exchange Act, including:¹⁵

- Section 3(a), as part of the definitions of “exchange”, “interstate commerce” and “exclusive processor.” The terms “interstate commerce” and “exclusive processor” appear in the Exchange Act 64 and four times, respectively.
- Section 5, which makes it unlawful for any broker, dealer or exchange to use the mails or interstate commerce for the purpose of using any facility of an exchange to effect or report any transaction in a security unless such exchange is registered or exempt from registration under the Exchange Act.
- Section 6(b), which requires the SEC to determine, in connection with the registration of a national securities exchange, that the rules of the exchange provide for the equitable allocation of reasonable dues and fees among persons using its facilities.
- Section 9 (four times), which prohibits persons from using any facility of any national securities exchange for the purpose of manipulating security prices (Section 9(a)), including through short sales of securities (Section 9(d)), practices that affect market volatility (Section 9(i)) and security-based swaps (the second Section 9(j)).
- Section 10, which contains the well-known prohibition on the use of the mails, interstate commerce or the facilities of a national securities exchange to, among other things, use any manipulative or deceptive device or contrivance in connection with the purchase or sale of a security.
- Section 11, which prohibits a broker-dealer from using any facility of a national securities exchange to effect a transaction in which the broker-dealer extends or arranges credit for a customer on new issue securities, if the broker-dealer participated in the distribution of the securities within the preceding 30 days.
- Section 11A (twice), which requires the SEC to facilitate a national market system.
- Section 13, as part of the definition of “large trader.”
- Section 14 (twice), which prohibits the use of the mails or interstate commerce or the facilities of a national securities exchange to solicit proxies or consents without complying with the proxy rules promulgated by the SEC (Section 14(a)) or to make tender offers for securities (Section 14(d)).
- Section 15, which makes it unlawful for unregistered brokers and dealers to effect or induce transactions in securities except where their business is exclusively intrastate and does not make use of any facility of a national securities exchange.
- Section 21A, which gives the SEC authority to impose civil penalties for insider trading.

¹⁴ 15 U.S.C. 78c(a)(2).

¹⁵ Excludes instances where “facility” is used as part of the term “security-based swap execution facility”.

The SEC also refers to facilities of the national securities exchanges in rules promulgated under the Exchange Act, such as Rule 19b-4. Supporters of the existing statutory definition of “facility” contend that if Congress is to amend the Exchange Act to curtail the SEC’s regulatory powers by changing the definition of “facility” as used with respect to an exchange, careful consideration must be given to the potential impact of that change in light of each of the provisions in the Exchange Act in which the term is used.

Use in Enforcement

Many of the provisions of the Exchange Act that include references to “facilities” of the exchanges serve as the basis for enforcement actions brought by the SEC, including Section 5, Section 6, Section 9, Section 11 and Section 14. The SEC often brings actions under Section 10(b) and Rule 10b-5, which prohibit manipulative activities in connection with securities transactions conducted through the use of the mails, interstate commerce or the facilities of a national securities exchange. For example, the SEC has brought successful enforcement proceedings under Section 10(b) and Rule 10b-5 against individuals for stealing investor funds in fraudulent securities offerings.¹⁶ In such cases, victims can be defrauded even though securities are never sold and funds are never invested through the exchanges. In circumstances where the mails and interstate commerce are not utilized, the limitation of the scope of “facilities” under the Exchange Act could reduce the SEC’s ability to bring enforcement actions.

Investor and Market Protections

SRO Rulemaking

The SEC’s authority over the SRO rulemaking process is a significant component of the SEC’s regulation of the national securities exchanges and the national market.¹⁷ Rule 19b-4 defines the “rules” of an exchange to include “any material aspect of the operation of the facilities” of the exchange or any statement with respect to the “rights, obligations or privileges” of exchange members or persons having or seeking access to the facilities of the exchange.¹⁸ Rule 19b-4 and the scope of the facilities of the exchanges has become an increasing focus as technology, the exchanges and the securities markets have evolved. Parties concerned about H.R. 3555 and any other potential proposals to weaken the scope of the SEC’s regulation of facilities of the exchanges are focused on the potential impact such changes might have on the ability of market participants to challenge the rules, policies and fees of the SROs for the products and services that are used by market participants.

Like the federal securities laws, the national securities exchanges have changed over time. Much of the activity that was once conducted in person on an exchange floor now occurs electronically, often being performed by the exchanges rather than by their members.¹⁹ As in the

¹⁶ See, e.g., *In the Matter of Craig Berkman, et. al.*, SEC File No. 3-15249 (March 19, 2013). See also <https://www.sec.gov/news/press-release/2013-2013-44htm>.

¹⁷ See 15 U.S.C. 78f(b), 15 U.S.C. 78s(b)(1) and 17 C.F.R. 240.19b-4.

¹⁸ See 17 C.F.R. 240.19b-4(a)(6)(i).

¹⁹ See Concept Release on Equity Market Structure, 75 Fed. Reg. 3594, 3598 (Jan. 21,

past, there are a limited number of national securities exchanges,²⁰ many of which are related under common ownership.²¹ As a result of there being relatively few national securities exchanges that comprise the overwhelming majority of the securities market and their positions as SROs within the national market system, these exchanges are the recipients and gatekeepers of information and services that are used by market participants such as broker-dealers.

In 1998, the SEC confirmed that the exchanges could structure themselves as for-profit entities rather than not-for-profits as they had traditionally been structured.²² Subsequently, all of the national securities exchanges reorganized as for-profit entities, with their boards of directors taking on fiduciary obligations to owners. Today, while retaining their member-regulatory functions as SROs, the exchanges are businesses that, in some lines of business such as listing and trade execution, compete with each other and with other marketplaces such as alternative trading systems. Business lines apart from listing and trade execution, such as the provision of market data, network and data co-location services, and order types comprise a much larger portion of exchange revenue and income than in the past.²³ The SEC considers such services to be a “material aspect of the operation of the facilities” of the exchanges²⁴ and therefore SEC review and approval of changes to SRO rules with respect to these services is required so that the SEC can perform its duties of promoting fair competition, fostering a free and open market, and protecting investors.²⁵

Flexibility of “Facilities” under the 1934 Act

The public statement released with respect to H.R. 3555 says that it is intended to account for “new business models” developed by the stock exchanges such as those “involving data management services, regulatory compliance technology and others.”²⁶ Supporters of the existing statutory definition point out that the SEC has historically administered the “facilities” definition flexibly, often either allowing exchanges to enter new areas without restriction or

2010).

²⁰ See <https://www.sec.gov/fast-answers/divisionsmarketregmrexchangesshtml.html>. There are also SROs that are not national securities exchanges which serve other functions in the national marketplace for securities, including the Financial Industry Regulatory Authority (FINRA), the Municipal Securities Rulemaking Board (MSRB), the Depository Trust Company (DTC), and several clearing agencies.

²¹ See In the Matter of Securities Industry and Financial Markets Association, Initial Decision dated June 1, 2016, finding that at such time there were eleven securities exchanges that could be grouped into four exchange “families.”

²² See SEC Release 34-40760 (Dec. 8, 1998).

²³ See Matt McFarland, “SEC Review Threatens Growth of Lucrative Market Data Fees,” Nov. 7, 2016 (<https://marketintelligence.spglobal.com/our-thinking/ideas/sec-review-threatens-growth-of-exchanges-lucrative-market-data-fees>).

²⁴ See Brief of the Securities and Exchange Commission, *Amicus Curiae*, City of Providence, Rhode Island, et. al. v. BATS Global Markets, Inc., et. al (2d Cir.) at 11-15.

²⁵ 17 CFR 240.19b-4.

²⁶ Press release of Representative Loudermilk dated August 11, 2017 (<https://loudermilk.house.gov/news/documentsingle.aspx?DocumentID=1167>).

crafting targeted conditions after review that allow the exchanges to offer products in new business lines while protecting the market and its participants. The SEC has shown a willingness and ability to interpret “facilities” narrowly under the Exchange Act when determining whether services fall within the scope of “facilities of the national exchanges.” For example:

- In 2007 the SEC determined that Nasdaq’s ACES system, which routes orders from one subscriber to another without requiring the order to be filled or routing the order to an exchange, is not a “facility” within the meaning of the Exchange Act.²⁷
- In 2008, Nasdaq proposed eliminating the Nasdaq rules that relate to fees for its index dissemination service, through which Nasdaq distributes values for indexes and exchange traded funds. The SEC permitted the change, reasoning that the index dissemination service is not a “facility” of the exchange. Consequently, the fees charged by Nasdaq in connection with the index dissemination service do not fall within the scope of the rules that must be filed with the SEC pursuant to Section 19(b)(1) and Rule 19b-4.²⁸
- Also in 2008, Nasdaq proposed a rule to eliminate fees relating to its Mutual Fund Quotation Service (“MFQS”), through which Nasdaq collects price data for mutual funds, money market funds, and unit investment trusts for transmission to market data vendors. The SEC approved the proposal noting that the fees charged in connection with the MFQS “do not fall within the scope of the rules that must be filed pursuant to Section 19(b)(1) of the Exchange Act and Rule 19b-4.” The SEC also noted that if Nasdaq were to propose to tie pricing for the MFQS to an exchange activity, or otherwise modify the MFQS such that it falls within the definition of facility of an exchange, Nasdaq would have to file a proposed rule change.²⁹
- In 2011, Nasdaq proposed rules related to Nasdaq’s Corporate Solutions business, which offers governance services, communications services and market analytics to public and private companies. Commenters argued that the proposal should not be permitted because it would allow Nasdaq to tie free corporate services to listing services, thereby effectively subsidizing the provision of corporate services through listing fees in a manner that would be harmful to other providers of such services.³⁰ Nasdaq argued, among other things, that the services were not a “facility” of the exchange. The SEC noted that “facility” is defined broadly in the Exchange Act and that “any determination as to whether a service or other product is a facility of an exchange requires an analysis of the particular facts and circumstances.” Without stating whether it accepted Nasdaq’s argument that the services did not fall within the meaning of “facility,” the SEC approved the

²⁷ See SEC Release No. 34-56237 (August 9, 2007).

²⁸ See SEC Release No. 34-58897 (November 3, 2008).

²⁹ See SEC Release No. 34-58392 (August 20, 2008).

³⁰ See SEC Release No. 34-65963 (Dec. 15, 2011). One commenter argued “Nasdaq, in its regulatory role, will, on the one hand, be informing new public companies of their public disclosure obligations while, on the other, be offering to provide them those very disclosure services for free.” Id.

proposed rules.³¹

Availability of Exemption Process

There is also a process by which the exchanges, like others subject to the Exchange Act, can seek exemptive relief. Section 36 of the Exchange Act, which was added under the National Securities Markets Improvement Act of 1996, permits the SEC to conditionally or unconditionally exempt any person, security or transaction from most of the requirements of the Exchange Act and the rules thereunder to the extent such exemption is necessary or appropriate in the public interest and consistent with the protection of investors.³² According to the SEC, Congress intended to grant broad authority under Section 36 “to incorporate flexibility into the Exchange Act regulatory scheme to reflect a rapidly changing marketplace. Congress particularly intended for the [SEC] to use this flexibility to promote efficiency and competition.”³³ The exchanges have sought and obtained exemptive relief under the Section 36 process. The exchanges also often use the SEC’s no-action process when seeking regulatory relief.

Notably, the SEC has granted Section 36 exemptions to the exchanges for new lines of business. For instance, in March 2000, Nasdaq agreed to purchase Financial Systemware, Inc. (“FSI”), a manufacturer of software products that it later renamed Nasdaq Tools, Inc. FSI offered “OTC Tools”, an order management system designed to assist broker-dealers in efficiently managing quotes, monitoring and executing incoming orders, checking for closed, locked or crossed markets, and monitoring depth-of-market information.³⁴ Nasdaq sought an exemption under Section 36 to complete the acquisition, to market OTC Tools and related software, to expand the services offered by FSI to include service bureau and back-office functions for broker-dealers, and to determine prices for such software and services, in each case without having to file proposed rule changes.³⁵ In April 2000, the SEC granted a one-year exemption subject to conditions designed to preserve competition, and solicited public comment in connection with its consideration of a permanent exemption.³⁶ In April 2001, the SEC granted a permanent exemption from the rulemaking procedures again subject to conditions designed to preserve competition, including that FSI’s products not be necessary for broker-dealers to access the exchange’s fundamentally important services, the provision of open architecture by the exchange to ensure the continued existence of effective competition for FSI’s products and services, and a prohibition on sharing information with FSI that is not available to the industry generally or competitors of FSI.³⁷

In this instance the SEC utilized the facilities definition as the basis for relief that enabled

³¹ See SEC Release No. 34-65963 (Dec. 15, 2011).

³² See Exchange Act Section 36(a), 15 U.S.C. 78mm(a).

³³ See SEC Release No. 34-44201 (April 18, 2001), 66 FR 21025.

³⁴ See SEC Release No. 34-44201 (April 18, 2001), 66 FR 21025.

³⁵ See SEC Release No. 34-44201 (April 18, 2001), 66 FR 21025.

³⁶ See Securities Exchange Act Release No. 42713 (April 24, 2000), 65 FR 25401.

³⁷ See SEC Release No. 34-44201 (April 18, 2001), 66 FR 21025. The SEC noted in its order that OTC Tools “does not change or alter the current features of Nasdaq, SelectNet or SOES (*i.e.*, the facilities of the NASD).” *Id.* at 21026.

the exchange to enter into new businesses under conditions designed to protect the broker-dealer and vendor communities. These conditions were meant to ensure that the SROs would not unfairly utilize information or tie the new products and services to existing critical products and services, and to ensure that competing order management systems could access the exchange on the same terms as those of the exchange-owned affiliate's order management system. Supporters of the current law contend that the facilities definition in use since 1934 is critical to the protection of competition, the constraint of fees and the encouragement of innovation with respect to the national securities markets, particularly given the limited applicability of antitrust protections to matters regulated by the SEC.³⁸

Market Data Feeds

Section 11A of the Exchange Act imposes additional requirements for rules relating to the dissemination of market data. To ensure the wide availability and equitable dissemination of market data, Section 11A requires broker dealers to provide certain market data to exclusive processors such as the national securities exchanges which in turn must distribute market data on terms that are "fair and reasonable" and "not unreasonably discriminatory."³⁹ Pursuant to Section 11A, the SEC has promulgated a series of regulations intended to encourage the wide availability and dissemination of market data. Regulation NMS requires national securities exchanges to collect and distribute a consolidated feed of all transaction reports and the best bid and offer for each security on each exchange.⁴⁰ This data is often referred to as "top-of-book" data. Top-of-book data is mandatorily provided by broker-dealers and reported by the exchanges to data processors, which then consolidate the data into a single stream and provide the consolidated feed to market participants for fees that according to the SEC "need to be tied to some type of cost-based standard in order to preclude excessive profits if fees are too high or underfunding or subsidization if fees are too low."⁴¹ Broker dealers also mandatorily provide data that is below the "top-of-book" – commonly referred to as "depth-of-book" data – which may be made available or not at the discretion of the exchange.⁴² If the exchange makes "depth-of-book" data available, then the fairness and anti-discriminatory requirements of Section 6 and Section 11A of the Exchange Act apply to fees and conditions for such data.⁴³

In the years since decimalization, depth-of-book data has become more critical for the industry to access because less information is available from the top-of-book feed.⁴⁴ Since

³⁸ See, e.g., *Gordon v. New York Stock Exchange, Inc.*, 422 U.S. 659, 95 S.Ct. 2598, 45 L.Ed.2d 463 (1975) and *In Re: Stock Exchanges Options Trading Antitrust Litigation*, 317 F.3d 134 (2d Cir. 2003).

³⁹ *Id.* § 78k-1(c)(1)(C), (D).

⁴⁰ See 17 C.F.R. 242.601-603.

⁴¹ Regulation of Market Information Fees and Revenues, Release No. 34-42208, 64 Fed. Reg. 70,613, 70,627 (Dec. 17, 1999).

⁴² Regulation NMS, 70 Fed. Reg. at 37,567

⁴³ See NYSE Arca Order, 73 Fed. Reg. at 74,779.

⁴⁴ See, e.g., Testimony, *The Effects of Decimalization on the Securities Markets*, of Laura S. Unger before the Subcommittee on Securities and Investment, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (May 24, 2001). "Decimalization" generally refers to

depth-of-book feeds will typically also include top-of-book data, SEC rules prohibit exchanges from releasing data in the depth-of-book feeds any sooner than they release the data for the consolidated feed.⁴⁵ However, because the data in the consolidated feed must be aggregated by a data processor, the exchange for-profit feeds generally reach market participants faster than the consolidated feeds.⁴⁶ Exchange for-profit feeds are attractive to traders and other market participants due to both their speed and content. FINRA requires its members and associated persons to “use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.”⁴⁷ While depth-of-book data has commercial importance, this “best execution” obligation is one of the reasons that access to depth-of-book data and the ability to obtain timely information is legally important for broker-dealers.

Pricing for depth-of-book market data feeds has been the subject of much contention among the SEC, the national securities exchanges and industry participants. Disputes over market data fees are often based on whether the fees charged by the exchanges are discriminatory towards other vendors, and therefore whether the Exchange’s rules meet the standards set forth in Section 6(b) of the Exchange Act. For example, in a 2007 comment letter to the SEC in connection with a proposed NYSE data feed, eSignal argued that the flat-rate fee structure of \$100,000 per month had no relation to the NYSE’s costs, which it estimated at a few thousand dollars per month, and unfairly discriminated against smaller purchasers of the feed who could not amortize the cost amongst a large subscriber base.⁴⁸ eSignal, which is now owned

the conversion of quotations in equity securities and options from fractional to decimal pricing.

⁴⁵ See Regulation NMS Release, 70 Fed. Reg. 37496, 37567 (June 29, 2005); *Lanier*, 838 F.3d at 152-53.

⁴⁶ See *id.*

⁴⁷ See FINRA Rule 5310. See also SIFMA Compliance and Legal Society Annual Seminar “Equity Trading and Institutional Sales Panel” (March 17, 2015) (Tom Gira, Head of Market Regulation, FINRA): “Another area I want to touch on was *best execution* and I think this could be the year of *best execution*. I think we’re really seeing it across all of our asset classes that we’re looking at and with respect to equities, we are still conducting our sweep where we’re looking at how firms are making routing decisions.... I think we’ve said this before, but again we don’t always see this universally, is that compliance with NMS is not necessarily achieving *best execution*. So [we’re] starting to looking at strategies where, if you’re just sort of clearing a book but not looking at *depth-of-book* type activity at other markets before you fill a customer, that’s another area where we’re going to start to focus a little bit more on.” (emphasis added) See also FINRA, Regulatory Notice 15-46, Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets, at 13 n.12 (2015) (“The exercise of reasonable diligence to ascertain the best market under prevailing market conditions can be affected by the market data, including specific data feeds, used by a firm. For example, a firm that regularly accesses proprietary data feeds, in addition to the consolidated SIP feed, for its proprietary trading, would be expected to also be using these data feeds to determine the best market under prevailing market conditions when handling customer orders to meet its best execution obligations.”).

⁴⁸ See Comment Letter on SRO Proposed Rule, eSignal, File No. SR-NYSE-2007-04 (March 27, 2007). Interestingly, among other arguments, eSignal noted that the proposed fee structure would encourage piracy of data feeds because while the high fixed rate price was

by Interactive Data Corporation (owned in turn by the same parent company as the NYSE), contended that “The Exchange proposes to allow web portals access to substantially the same real-time data for an unlimited number of users at a capped fee that is a fraction of what brokers and market data vendors pay to service many fewer users...we believe the high level of proposed prices unreasonably discriminates against smaller distributors.”⁴⁹ eSignal was concerned that the exchange was in a position to leverage its single-source provider status by favoring certain vendors in its pricing over other market participants who do not control the data or set prices.

In 2006, the NYSE filed a proposed rule change with the SEC to impose fees for its ArcaBook depth-of-book product, which had previously been free.⁵⁰ At the time, rules changes related to fees were not immediately effective. The SEC’s Division of Market Regulation approved rule changes imposing the fees, which was then affirmed by the SEC upon review.⁵¹ NetCoalition, a now defunct organization of internet service providers and the Securities Industry and Financial Markets Association (“SIFMA”), the major trade association of the financial services industry, challenged the SEC’s approval in 2008.⁵² The U.S. Court of Appeals for the District of Columbia Circuit (the “DC Circuit Court of Appeals”) agreed with NetCoalition and SIFMA in a 2010 decision commonly referred to as “NetCoalition I,” vacating the SEC’s order approving the ArcaBook fee changes and finding, among other things, that the record was insufficient to show that the fees satisfied the “fair and reasonable” standard of the Exchange Act and that there was no “reasoned basis” for the SEC’s conclusion that competitive forces constrained pricing on the ArcaBook data.⁵³ The NetCoalition I decision relied heavily on Section 6(b) of the Exchange Act, which requires the SEC to determine, in connection with the registration of a national securities exchange, that the rules of the exchange provide for the equitable allocation of reasonable dues, fees and other charges among persons using its facilities.

Subsequent to the NetCoalition I decision, Congress amended the Exchange Act by enacting the Dodd-Frank Act in 2010 in response to the financial downturn experienced in 2008. The Dodd-Frank Act amendments eliminated the SEC prior approval requirement for certain SRO rule changes, including changes to rules setting fees. Under the Dodd-Frank Act amendments, rules changes related to fees for market data take effect upon filing with the SEC, with the SEC having the authority to suspend a rule change and trigger notice and comment approval proceedings in the event that the SEC deems such action necessary and appropriate to the public interest, the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.⁵⁴ Taking advantage of this immediate effectiveness, NYSE and Nasdaq made filings in late 2010 setting fees for four non-core market data products, including resubmitting the fees for the ArcaBook product that were the subject of NetCoalition I.⁵⁵ NetCoalition and

insignificant to large web portals such as Yahoo! and MSN, smaller users will turn to the web portals to obtain (and perhaps repackage) the data rather than paying the NYSE’s fee.

⁴⁹ Id.

⁵⁰ See SEC Release No. 34-53952 (June 7, 2006).

⁵¹ See 2008 ArcaBook Order, 73 Fed. Reg.

⁵² See NetCoalition v. SEC (NetCoalition I), 615 F. 3d 525 (D.C. Cir. 2010).

⁵³ NetCoalition v. SEC (NetCoalition I), 615 F. 3d 525 (D.C. Cir. 2010).

⁵⁴ See 15 U.S.C. 78s(b)(3)(A); 17 CFR 240.19b-4(f)(2), (f)(6).

⁵⁵ See Release No. 34-63351, 75 Fed. Reg. 73,140 (Nov. 29, 2010), Release No. 34-62887,

SIFMA subsequently petitioned the SEC to suspend each of the fee-setting rules, contending that they were unlawful under NetCoalition I. The SEC refused to do so, and NetCoalition and SIFMA again challenged in the DC Circuit Court of Appeals, which consolidated the various rule challenges into a single case.⁵⁶

In 2013, in a decision commonly referred to as “NetCoalition II,” the DC Circuit Court of Appeals upheld NetCoalition I’s determination that there must be evidence that competition will in fact constrain pricing for market data in order for fees to be considered fair and reasonable.⁵⁷ However, the court refused to provide the relief requested by NetCoalition and SIFMA because the Dodd-Frank Act had eliminated the SEC approval requirement for fee-related rules, negating the process by which those fees had been challenged in NetCoalition I.⁵⁸ Instead, the DC Circuit Court of Appeals confirmed that Sections 19(d) and 19(f) of the Exchange Act permit a party that is aggrieved by fee changes to challenge them as inconsistent with the Exchange Act, including through judicial review following such process, noting that “if unreasonable fees constitute a denial of ‘access to services’ under Section 19(d) and 19(f), we have authority to review such fees.”⁵⁹

Sections 19(d) and 19(f) have been relied on in appeals to the SEC with respect to actions of the SROs. For example, in a 2004 order, the SEC agreed with Bloomberg L.P. that limitations imposed by the NYSE on Bloomberg’s ability to transmit market data in certain formats constituted a denial of access to services. The order stemmed from an appeal by Bloomberg regarding contractual restrictions imposed by the NYSE which Bloomberg agreed to “under explicit protest and with full reservation of rights.” The restrictions obligated Bloomberg to include certain additional information and formatting on any displays of the data feed being provided by the NYSE and gave the NYSE approval rights with respect to all displays and any changes thereto. The SEC confirmed that the contractual requirements constituted rules that relate to a “material aspect of the operation of the facilities of the self-regulatory organization” and set them aside as requested by Bloomberg.⁶⁰

In the years since NetCoalition II, SIFMA has continued to challenge the non-core market data fees at issue in the case under the Sections 19(d) and 19(f) process, resulting in an order of an administrative law judge issued in June 2016 denying SIFMA’s challenge.⁶¹ SIFMA has appealed the ruling and it is now pending Commission review. Meanwhile, the exchanges continue to make rule changes related to market data fees that become effective without the need for SEC approval, and the U.S. Department of Treasury recently released a report recommending that the SEC recognize that the market for data feeds “is not fully competitive” and consider

75 Fed. Reg. 57,092 (Sept. 17, 2010), Release No. 34-62907, 75 Fed. Reg. 57,314 (Sept. 20, 2010), and Release No. 34-63291, 75 Fed. Reg. 70,311 (Nov. 17, 2010),

⁵⁶ NetCoalition v. SEC (NetCoalition II), 715 F. 3d 342 (D.C. Cir. 2013).

⁵⁷ NetCoalition v. SEC (NetCoalition II), 715 F. 3d 342 (D.C. Cir. 2013).

⁵⁸ NetCoalition v. SEC (NetCoalition II), 715 F. 3d 342 (D.C. Cir. 2013).

⁵⁹ NetCoalition v. SEC (NetCoalition II), 715 F. 3d 342 (D.C. Cir. 2013).

⁶⁰ SEC Release No. 34-49076 (Jan. 14, 2004).

⁶¹ In the Matter of Securities Industry and Financial Markets Association, Initial Decision (Public) dated June 1, 2016.

principles of fairness, non-discrimination and equitable allocation in determining whether to approve SRO rule changes that set data fees.⁶²

SIFMA also challenges other market data fee and rule filings by the exchanges under the Sections 19(d) and 19(f) denial of access process. For example, in April 2017 it challenged a Consolidated Tape Association filing that it contended raised the cost of certain top-of-book data to small broker-dealers by more than 2,000% by changing what is considered to be display and non-display use of such data.⁶³ CTA subsequently withdrew the rule filing at issue.

Fees for regulatory data have also been challenged under Sections 19(d) and 19(f). Under FINRA Rule 4650, member firms are required to provide their total customer short positions for securities to FINRA.⁶⁴ FINRA then aggregates the short positions of all firms for each security and makes the report for each security available to the exchange that has primary listing responsibility for that security. The exchanges in turn can then publish this data, as Nasdaq does in its “Short Interest Report” which summarizes the short interest positions for all Nasdaq-listed issues as reported by FINRA.⁶⁵ On July 28, 2017, the SEC published a notice of a Nasdaq fee change for the Short Interest Report.⁶⁶ Under the revised fee structure, distributors who distribute the Short Interest Report more than once per month to more than 10,000 customers would see their fees increase from \$2,500 per month to \$7,500 per month.⁶⁷ As with the depth-of-book data that has been subject to challenge since 2008, these fee increases became immediately effective and can only be challenged through the Section 19(d) and 19(f) process as facilities of the exchanges. SIFMA, displeased on behalf of its members with the immediate 300% cost increase, has done so.⁶⁸

Other Services and Products that are Facilities

Like market data feeds, co-location services and order types are also considered by the

⁶² U.S. Department of the Treasury, *A Financial System that Creates Economic Opportunities: Capital Markets* (October 2017) at 64. “Treasury recommends that the SEC also recognize that markets for SIP and proprietary data feeds are not fully competitive. The SEC has the authority under the Exchange Act to determine whether the fees charged by an exclusive processor for market information are ‘fair and reasonable,’ ‘not unreasonably discriminatory,’ and an ‘equitable allocation’ of reasonable fees among persons who use the data. The SEC should consider these factors when determining whether to approve SRO rule changes that set data fees.” *Id.*

⁶³ See Letter of Melissa MacGregor to Brent J. Fields, dated April 18, 2017.

⁶⁴ See FINRA Rule 4650.

⁶⁵ See SEC Release No. 34-81256 (July 28, 2017). “[I]t is designed to facilitate the distribution of short sale data to the media and assist investors and traders in developing risk-assessment tools and trading models for Nasdaq-listed issues.”

⁶⁶ See SEC Release No. 34-81256 (July 28, 2017).

⁶⁷ *Id.* The revised structure also provides opportunities for reduced pricing based on meeting certain monthly spending thresholds for other Nasdaq products and licenses.

⁶⁸ See Application for an Order Setting Aside Rule Changes of Certain SROs Limiting Access to their Services (Aug. 28, 2017).

SEC to be “facilities” of the exchanges.

Co-location Services. Co-location is a service offered by securities exchanges that enables market participants to obtain faster access to exchange information by permitting trading firms to place servers at exchanges’ data centers in order to have direct access to trading data.⁶⁹ Under the Exchange Act, the terms of co-location services offered by exchanges must not be unfairly discriminatory, and the fees must be equitably allocated and reasonable.⁷⁰ The exchanges are not permitted to provide data to co-location customers prior to the time that such data is reported to the securities information processor for public dissemination, but the direct data feeds can allow firms to receive and act on information microseconds prior to the time the information is published by in public data feed.⁷¹ The SEC has approved the terms of particular co-location services as consistent with the Exchange Act and, like market data fees, amendments to fees associated with co-location services may be filed as immediately effective rule changes.⁷²

Order Types. Exchanges also offer a range of order types that govern the manner in which the exchanges will process orders in their trading systems, route orders to other exchanges, and execute trades. Over time, the exchanges have developed a large number of new and increasingly complex order type products that are used by traders, including high-frequency trading firms, to more precisely specify the parameters for execution of orders. Like co-location services, the SEC has reviewed and exercised its authority to approve numerous exchange rules related to order types as facilities of the exchanges.⁷³

Consolidated Audit Trail. In November 2016, the SEC approved a plan to create a single, comprehensive database that would enable regulators to efficiently track all trading activity in the U.S. equity and options market.⁷⁴ The plan for the database, known as the consolidated audit trail (CAT), was submitted jointly by the SROs under Regulation NMS, which have since filed amendments to the plan. In July 2017, the SEC abrogated an amendment filing made by the SROs with respect to the CAT that established a fee structure for participants and industry members under the plan. In abrogating the amendment, the SEC found that the proposed fee structure “raises questions as to whether the allocation of the total CAT costs recovered...is reasonable, equitable, and not unfairly discriminatory” under the Exchange Act.⁷⁵ As the industry costs for the creation and maintenance of the CAT are expected to be high, supporters of the existing “facility” definition believe it is critical that the SEC maintain its authority over the facilities of the exchanges to be able to ensure that such costs are borne equitably by market participants.

⁶⁹ See Adam J. Wasserman, *Colocation Takeaways from the NYSE Settlement* (July 7, 2014).

⁷⁰ See Exchange Act Section 6(b)(4), 6(b)(5), 15 U.S.C. 78f(b)(4), (5).

⁷¹ See Wasserman, *Colocation Takeaways from the NYSE Settlement*.

⁷² See, e.g., Exchange Act Release No. 62397, 2010 WL 2589819 (June 28, 2010) and Exchange Act Release No. 71200, 2013 WL 6858802 (Dec. 30, 2013).

⁷³ See, e.g. Exchange Act Release No. 34-81131 (July 12, 2017) and Exchange Act Release No. 34-77880 (May 20, 2016).

⁷⁴ See Exchange Act Release No. 34-79318 (Nov. 15, 2016).

⁷⁵ See Exchange Act Release No. 34-81189 (July 21, 2017).

New Technologies

In a recently released report, the SEC set forth its view that cryptocurrency token exchanges and other exchanges employing blockchain technology could be required to register as national exchanges.⁷⁶ In the report, the SEC focused on The DAO, which was a “decentralized autonomous organization,” a term used to describe a virtual organization embodied in computer code and executed on a distributed ledger or blockchain.⁷⁷ The SEC examined the characteristics of tokens sold by the DAO and exchanged in certain secondary marketplaces by investors, concluding that the DAO’s tokens were securities and cautioned anyone that would use distributed ledger or blockchain-enabled means for capital raising to take appropriate steps to ensure compliance with the federal securities laws.⁷⁸ Parties who are concerned about H.R. 3555’s potential impact and unintended consequences wonder whether it makes sense to curtail the SEC’s ability to determine what constitutes a “facility of the exchange” precisely at a time when emerging technology is driving new types of marketplaces for securities.

The Impact of H.R. 3555

H.R. 3555 or an amendment like it could have unintended consequences. The bill would change a definition that has been in place since 1934, appears in numerous provisions of the Exchange Act and SEC rules thereunder, and has been relied on in connection with the SEC’s authority to regulate aspects of the national securities market in many SEC and court orders and decisions. Proponents of the existing statutory definition believe that the limited public statements made in connection with the bill fail to make clear exactly what problem the sponsors are attempting to address with respect to the SEC’s current regulatory authority and why H.R. 3555 is the proper measure to address that undefined problem. They argue that the absence of any solicitation of comments from market participants has resulted in a bill that is not narrowly tailored to accomplish specific goals and instead could result in years of litigation to determine the extent of its effects.

Supporters of the existing statutory language argue that the notion of promoting innovation and growth by limiting the SEC’s authority is at odds with Congressional intent and history. Faced with new technologies in the past, such as in 1975, they argue that Congress purposefully gave the SEC broad authority and a mandate to foster a national market that can make use of new technologies in a fair, competitively neutral manner, recognizing that the registration of national exchanges and delegation of power to the SROs has the effect of limiting the number of competitors and concentrating certain benefits of technology, legal status and market participation in relatively few hands.

Representative Loudermilk’s press release regarding H.R. 3555 states that the proposed amendment “will not exempt functions of exchanges that are material to securities trading from [SEC] supervision, such as market data, listing standards, and colocation.” The bill, according to

⁷⁶ See SEC Release No. 81207, July 28, 2017.

⁷⁷ Id.

⁷⁸ Id.

the statement, is intended to account for “new business models” developed by the stock exchanges such as those “involving data management services, regulatory compliance technology and others.”⁷⁹ However, H.R. 3555 would make significant changes to the core definition of “facilities” for the first time since 1934, raising the possibility of unintended consequences and unknown implications in a number of areas which may end up being resolved through litigation. Market participants are debating many questions such as:

- What are the implications for the ability of investors and other market participants to challenge exchange regulations?
- How will SEC enforcement be affected?
- What are the implications for market data, including pending market data pricing litigation?
- What are the implications for other products and sectors, such as co-location, order types and high frequency trading?
- How will cost allocation for the Consolidated Audit Trail and other major market infrastructure projects be affected?
- What are the implications for emerging platforms and technologies?
- What effects have not been anticipated?

Congress should address these issues before considering this type of legislation.

⁷⁹ Press release of Representative Loudermilk dated August 11, 2017.