

## RULES AND REGS

### Multi-Million Dollar Data

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*The persistent problem of market data just won't go away. As part of a new concept release on self-regulation, the SEC has once again raised the issue of how the marketplace should pay for the collection and distribution of market data. Should competition or regulation determine price? Look for this pocketbook issue to figure prominently on the SEC's 2005 docket.*

As anyone in the trading industry can tell you, data is the lifeblood of the marketplace. We need market data for price discovery and risk management; we need market data for aggregators and algorithms. But while its importance is well known, the process and the economics of consolidating and distributing data remains a mystery to many.

#### Real Money

Here's how it works: Market data revenue is collected by the exchanges and Nasdaq via the sale of "tick data" — best quotes and trade reports — to market data vendors. In turn, these vendors resell the data to market participants, along with value-added analytics. The exchanges and Nasdaq set prices collectively under SEC oversight. The data is collected and priced via three "networks:" "Tape A" for NYSE listings, "Tape B" for Amex, and "Tape C" for Nasdaq.

According to the SEC, in 2003 the exchanges and Nasdaq collected a total of \$424 million in market data revenue at an aggregate expense of \$38 million. That's real money at a 90%+ margin—nice work if you can get it. The exchanges and Nasdaq divvy up the kitty amongst themselves based on share of trades for listed names and the share of trades and volume for Nasdaq securities.

In our beleaguered business of constant margin compression, why does the seemingly pedestrian business of collecting and distributing bits and bytes offer such rich rewards? Because consumers have no choice. The SEC requires brokers to buy market data from a monopoly consolidator, ensuring demand and eliminating the incentive to price competitively and innovate. The contrast between the \$424 million annual bill for tick data with the near-free data offered by ECNs for full depth-of-book data is startling. The ECNs provide better data at substantially lower prices.

#### Fourth Bite at the Apple

Never comfortable in the role of rate maker, the SEC has revisited in various ways the issue of market data economics four times in recent years: The Market Data Concept Release (1999); the Advisory Committee on Market Information (2000-01), proposed Regulation NMS (February 2004), and the Self-Regulation Concept Release (November 2004). In proposed Regulation NMS, the SEC recognized that current market data economics are problematic. But rather than address the real problem—the size of the

\$424 million/year market data pie—the SEC proposed a complicated tweak to the formula used to carve it up. It was an approach only an economist could love—and most didn't.

In its just-released Self-Regulation Concept Release, the SEC seems to have moved past the hands-on approach of Regulation NMS to instead raise a fundamental question: Should market data revenues be collected to fund regulation? In other words, should exchanges and Nasdaq charge for regulation directly, or via market data fees?

It's a little bit like asking if the best way to pay Michael Jordan to play basketball is at a salary based on what he'd fetch as an outfielder. Clearly, some exchanges will offer better market data than others. Same with regulation. Furthermore, the value of market data and regulation will vary through time and isn't necessarily correlated. Indeed, more automated markets—those with more valuable data—may be cheaper to regulate. Moreover, while market data has become more abundant—and therefore cheaper—in recent years, recent miscues at the NYSE and Amex suggest the opposite might be true of regulation.

### **Of Rebates and Shredders**

At the Regulation NMS hearing in May, Nasdaq's Bob Greifeld indicated that market data charges should be cut by 60% to 75% to reach a fair price. His point is validated by industry practice. A number of marketplaces share up to 50% of their tape revenue with market participants, suggesting that the data's true value is substantially less than its list price. On the one hand, rebates return some of the excess market data rents to investors; on the other hand, in Amex-listed ETFs, they have led to "tape shredding" (breaking large orders into 100-share prints) and locked markets (as traders attempt to capture rebates), not to mention wash sales (reporting transactions that have no economic value). These unsavory practices dilute the value of the tape and are a direct result of twisted incentives.

Along these lines, some predict that when Nasdaq moves QQQ from Amex to its own marketplace on December 1, volume in comparable ETFs that remain on Amex—such as SMH—will increase as a consequence. In other words, because trading for Amex tape revenue via rebates in QQQ will no longer be possible, rebate-traders will migrate to other securities in order to capture the rebate. What better evidence to illustrate that market data is priced out of proportion to value?

### **Competition or Regulation?**

If regulation has failed to price data properly, what about competitive forces? In the past, the SEC has considered a "competing consolidator" approach under which vendors would have some choice in the matter. But as long as the SEC treats certain data elements—such as best quotes and reported trades—as part of the public domain, regulation will be part of the equation.

Three suggestions for the SEC come to mind. First, the artificial linking of market data fees and regulation creates inefficient cross-subsidies. Let marketplaces charge what the market will bear for both. Second, if some portion of market data—again, best quotes and reported trades, perhaps—belongs in the public domain, let the current co-operatives operate at cost, not 90% margin. Third, draw a clear distinction between the public domain and the private sector, so that marketplaces have incentives to

create innovative market data products and vend them on the open market. Given the importance of trading technology to investors today, the opportunity cost of lost market data innovation could be substantial.

It remains to be seen whether competition, regulation, or some combination of the two presents the best way forward to handle market data. Since we're all consumers, we've all got a stake in the outcome. Expect a healthy discussion in 2005.

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