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D.C. Circuit Vacates Proposed Fee For NYSE Arca "Depth-Of-Book" Data And Remands To SEC For Further Review

In *NetCoalition v. Securities & Exchange Commission*, No. 09-1042 (D.C. Cir. Aug. 6, 2010), the United States Court of Appeals for the District of Columbia Circuit held that the Securities & Exchange Commission ("SEC" or "Commission") failed adequately to explain the basis of, and failed to provide adequate support for, its approval of a proposed fee by NYSE Arca for access by investors to its proprietary "depth-of-book" product, Arcabook. The Court vacated the approval order and remanded the matter to the SEC for further consideration of whether the proposed fee is consistent with the requirements and purposes of the Securities Exchange Act of 1934 ("Exchange Act").

NYSE Arca is an all-electronic U.S. trading platform that provides fast execution with open, direct and anonymous market access. It is registered with the SEC as a national securities exchange and, as a registered "self-regulatory organization," is subject to the Commission's oversight. Like all other national securities exchanges, NYSE Arca is required to file its governing rules (which include fees charged to investors) with the SEC, which are subject to approval by the Commission if they are consistent with the requirements of the Exchange Act. Commission orders are subject to direct appellate review by the D.C. Circuit.

In May 2006, NYSE Arca filed a proposed rule change with the SEC that would allow it to charge a fee for its depth-of-book data, which previously was available at no cost. Depth-of-book data consists of outstanding limit orders to buy stocks at prices higher or lower than the best prices on the exchange.

NYSE Arca took the position that its proposed fees conformed to the Exchange Act and regulatory requirements because (1) "the proposed market data fees would reflect an equitable allocation of its overall costs to users of its facilities," and (2) its fees were "fair and reasonable because they compare favorably to fees that other markets charge for similar products." After public comment, the SEC approved the proposal in an order dated December 2, 2008. The SEC made its decision utilizing a "market-based approach." Based upon that methodology, the SEC concluded that NYSE Arca was subject to at least two types of significant competitive forces and there was no countervailing basis under the Exchange Act to disapprove the proposal.

Petitioners NetCoalition and the Securities Industry and Financial Markets Association sought review of the SEC Order on three grounds. First, petitioners contended that the SEC's market-based approach to evaluating the Arcabook fees conflicted with the Exchange Act. The Court, which evaluated the Commission's interpretation of the Exchange Act under the two-step analysis enumerated by the Supreme Court in [*Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*](), 467 U.S. 827 (1984), disagreed. The Court held that the SEC's construction of the statute was permissible. Under *Chevron*, if "Congress has directly spoken to the precise question at issue" the Court will "give effect to the unambiguously expressed intent of Congress." If the statute is silent regarding the issue, the Court will "accept the agency's interpretation of the statute as long as it is reasonable." In this case, because the Exchange Act is silent regarding utilizing a market-based approach, the Court evaluated the reasonableness of the SEC's interpretation. In examining the legislative history of the statute, the Court concluded that "Congress did not intend to take away the SEC's authority to rely, at least in some circumstances, on the market." Accordingly, the Court held that using "a market-based approach to evaluating whether NYSE Arca's non-core data fees are 'fair and reasonable'" was a permissible interpretation of the statute.

Second, petitioners contended that the SEC arbitrarily rejected its prior cost-based approach in approving NYSE Arca's proposed fees. They cited two examples of alleged departures from the cost-based approach, which the Court held did not fit the petitioner's characterization. Neither example showed that the SEC intended to require that fees be cost-based for an exchange's proprietary non-core data. The Court further determined that recent SEC pronouncements demonstrated that the Commission's market-based approach was not an unexplained shift, and that the market-based approach did not arbitrarily depart from prior practice.

Finally, petitioners argued that the SEC's conclusion that NYSE Arca was subject to significant competitive forces that constrained its ability to set fees for market data was not supported by substantial evidence. The Court agreed. Although the Court upheld the SEC's market-based approach, it did *not* conclude that a cost analysis was irrelevant. Indeed, pricing can be evidence of monopoly or market power. NYSE Arca's proposal even recognized that costs are relevant in determining the reasonableness of its fees. Moreover, NYSE is one of the larges exchanges in the nation, and it is the exclusive provider of the Arcabook data.

The SEC had concluded that NYSE Arca could not exercise market pricing power for Arcabook, but the Commission did not require NYSE Arca to substantiate its market data costs. Instead, the Commission recognized "the difficulty of cost calculation in determining whether a fee is fair and reasonable." Petitioners argued that the SEC's failure to consider NYSE Acra's costs was arbitrary and capricious because such a cost analysis is not difficult. In reaching its decision, the SEC had concluded that a consideration of costs was not necessary because NYSE Arca is subject to "[a]t least two broad types of significant competitive forces" in pricing Arcabook. Namely, "(1) [its] compelling need to attract order flow from market participants[] and (2) the availability to market participant of alternatives to purchasing the ArcaBook data."

In examining the record, the Court found that the Commission's determination failed the reasoned decision-making standard of the Administrative Procedures Act ("APA"), which provides that an agency's result must not only "be within the scope of its lawful authority, but the process by which it reaches that result must be logical and rational." First, the Court found that the SEC's conclusion that order flow competition constrains the pricing of Arcabook was at odds with the Commission's own statements that depth-of-book data was not important to most traders. There also was a lack of support in the record to support the SEC's conclusion that order flow competition constrains market data prices.

Second, the Court also found that the SEC's conclusion that alternatives to Arcabook exist does not necessarily preclude market power. An analysis of market competitiveness focuses on the customer's price sensitivity. The SEC's Order did not include any analysis regarding the number of potential users of the data or how they might react to price changes. Without evidence regarding trader behavior, the Commission did not adequately support its determination.

Because it found the record insufficient to perform an APA review of the SEC's Order, the Court vacated the Order and remanded the matter back to the Commission for further proceedings. The Circuit Circuit's ruling in *NetCoalition* continues the Court's recent trend of thoroughly examining the SEC's rulemaking process to ensure that the Commission fully and completely evaluates each proposed rule change for compliance with the Exchange Act.

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