EDWARD KNIGHT
EXECUTIVE VICE PRESIDENT

NASDAQ®

23

August 4,2003

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AUG 0 5 2003
OFFICE OF THE SECRETARY

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Petition for Commission Action Concerning *the* Trading of Nasdaq-Listed Securities, File No. S7-11-03

Dear Mr. Katz:

In its Request for Comment on The Nasdaq Stock Market, Inc.'s ("Nasdaq") Petition Relating to the Regulation of Nasdaq-Listed Securities ("Petition"), the Securities and Exchange Commission ("Commission") solicited suggestions for uniform rules that would create fairer, more orderly markets for Nasdaq securities.[1] Consistent with the Petition and its focus, Nasdaq urges the Commission *to* adopt a uniform rule requiring market participants to quote and trade Nasdaq securities in a consistent monetary increment or "minimum price variation" ("MPV"), with the exception of average priced trades.[2] Nasdaq believes that the existing quotation environment in which market participants use quotation increments ranging from pennies to hundredths of pennies harms investors by creating a two-tiered market, one for average investors and another for professionals, undermining the operation of important Commission and self regulatory organization ("SRO") rules and policies, reducing price Competition, increasing trading costs, and reducing price competition.

The lack of uniformity in pricing convention, with some market participants quoting and trading in increments smaller than the public quote is a chronic problem, as the Commission noted in its Request for Comment on the Effects of Decimal Trading in Subpennies.[3] Even before April of 2001, when the markets completed the transition from fractional to decimal quoting and trading, some **market** participants quoted and traded stocks in smaller increments

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1 Exchange **Act** Release No. 47849 (May 14,2003) **at** Question 5.

2 Chairman Donaldson has questioned whether the current decimalized environment benefits investors and suggested examining whether a larger MPV would benefit investors more. ***See*** *SEC Aide Urges* ***Look*** *At Trade* ***in*** *Decimals*, Wall Street Journal, May 14, 2003. Nasdaq supports a full examination of this issue. **A** necessary first **step** is ensuring a uniform quoting and trading increment.

3 Exchange Act Release No. **44568** (July 18,2001).

than the public MPV, consequently Nasdaq's Automated Confirmation Transaction Service **("ACT")** (which **accepts** trade reports from Nasdaq market participants), and its securities information processor facilities (which accepts trade reports from other market centers), have accepted trade reports out to six decimal places for many years. Between 1999 and 2001, for example, sub-MPV trades (i.e., 1/64th or 1/128th) represented roughly five **percent** of all trades and shares executed on or reported to Nasdaq.[4]

In the last year, however, the character of sub-MPV quoting and trading in Nasdaq securities **has** changed in two related and, Nasdaq believes, harmful ways, increasing the incidence of sub-penny trading to 16 percent of **all** trades in Nasdaq securities. First, sophisticated order routing systems that are calibrated to sub-penny increments have become widespread among broker/dealers and professional traders. These systems gather quotation information from SROs and electronic communications networks ("ECNs"), rank those quotations in increments **as** small as 1/100th of a penny, and then send orders to the best available quotations based upon those rankings. Second, in response, more market makers, ECNs and order routing systems have begun accepting limit orders and displaying quotations in sub-penny increments. Absent Commission action, more market participants (including Nasdaq) will feel compelled to follow these practices in the coming months to preserve their competitive positions and such action could have a profound impact on the equity markets.

Nasdaq fully supports increased competition in the marketplace, particularly **quote** competition, which ordinarily benefits all investors. That is not true of sub-penny quoting and trading today. Sub-penny quoting does not benefit all investors and has the perverse effect of decreasing price competition. Investors today do not have an equal opportunity to benefit from sub-penny quote competition. Ordinary investors do not see, much less have **the** opportunity to interact with, sub-penny quotations; that opportunity seems **reserved** for professional and day traders. The National Best Bid/Offer ("NBBO"), which the Commission has always considered a critical foundation of accuracy and investor protection, does not show sub-penny quotes to ordinary investors. Most traditional and electronic brokerage firms that serve ordinary investors limit their clients to placing orders in whole penny increments. Sub-penny quotes and orders are hidden **beneath** the surface of ECNs and sophisticated order management systems used by professionals.

The re-emergence of these hidden markets, which the Commission strove to eliminate through the Order Handling Rules, harms investors in numerous ways. Hidden markets facilitate and, indeed, encourage the practice of "stepping-ahead" of customer orders by economically insignificant amounts, reducing the display of customer limit orders and liquidity generally. Sub-penny quotes also contribute to the incidence of "flickering" quotes, which makes it difficult for broker/dealers to comply with best execution responsibilities, short sale regulation, and other market rules. They also cause broker/dealers to expend significant time and money to redesign

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4 *See* Impact of Decimalization on The Nasdaq **Stock** Market, Final Report to **the** SEC, June 11,2001.

automated systems (far internal operations, screen displays, and capacity) with little or no benefit to investors or **the** U.S. securities markets.

In addition to eliminating hidden markets, the Order Handling Rules were intended to increase **price** cornpetition in quoting. Sub-penny quotes may have the contrary effect of decreasing quote competition by destroying investors' incentives to post aggressive prices. If the incremental cost of acquiring price priority is trivial, then there is little incentive to improve price to attract an execution. While investors may try to maintain priority by quoting on systems that only recognize whole pennies, the existence of sub-penny based order routing systems has the **same** effect on priority as if the quote were placed on a sub-penny system. The end result is that priority is lost and the incentive to post aggressive prices reduced.

Nasdaq strongly believes that a rule establishing a uniform MPV is essential to investor protection. Investors will be best served by a uniform rule establishing a penny quotation increment, though any uniform rule -- even one establishing a sub-penny increment -- would be preferable to today's chaotic quotation environment. Like those rules raised in Nasdaq's Petition, the lack of a uniform quotation increment is an issue that neither Nasdaq nor any **other** market can overcome alone. Only the Commission can address it, using its authority under Section 11A of the Exchange Act to facilitate the establishment of a national market system "having due regard for the public interest, the protection of investors, and the maintenance of **fair** and orderly markets."

If the Commission does not act quickly, Nasdaq will be forced to compete on the basis of current policy. In fact, Nasdaq is filing today a proposal to amend its quotation increment to place itself on the same footing as its competitors in the market for execution services.

The Uneven Quotation Increment Creates Hidden Markets

Currently, quotation conventions vary at every structural level of the national market system and often between entities at the **same** level, including securities information processors ("SIPs"), SROs, broker/dealers and ECNs, market data vendors, order routing systems, and online brokers serving public investors. Due to the disparity in quotation conventions across market participants, the price at which a public investor's order is displayed and executed varies greatly and is largely unpredictable. Public investors have almost no ability to compare these practices, much less control or judge them. In fact, many investors are completely unaware of the differences in quoting and trading conventions and the vast effect those differences have on the regulatory protections and the quality of execution they receive.

The description below is only a.partial picture of the disparities that exist in quoting conventions today.

- *Public Investors*. Ordinary retail investors are generally unaware of the role of sub-penny trading in the marketplace. If aware, these investors are often limited to submitting orders in penny increments, although some brokerages accept customer orders in sub-pennies. Some traditional brokerage firms are capable of processing sub-penny orders, but as a matter of course receive **few.** Online brokerages like Ameritrade, TD Waterhouse, Schwab, and E*Trade accept public customer orders only in penny increments. Direct access firms often used by some sophisticated clientele such as day traders and hedge funds typically accept orders in sub-penny increments.

- *ECNs and **Market** Makers*. Nasdaq participants accept orders and execute trades in sub-penny amounts -- including both ECNs and market makers. ECNs such as The Island ECN, BRUT, and Instinet Corporation accept, display and execute orders in sub-penny amounts. Island ECN displays and executes orders up to 3 decimal places for all stocks. Instinet displays and executes orders up to 3 decimal places for stocks priced below $10, and BRUT displays and executes orders up to 4 decimal places for all stocks. Although market makers generally quote in penny increments only, they often offer sub-penny price improvement to customer orders. Finally, several so-called "black box" systems such as POSIT use sub-penny increments to match customer orders at the midpoint of the bid and ask quotation in stocks with a penny spread and **also** to report average price trades.

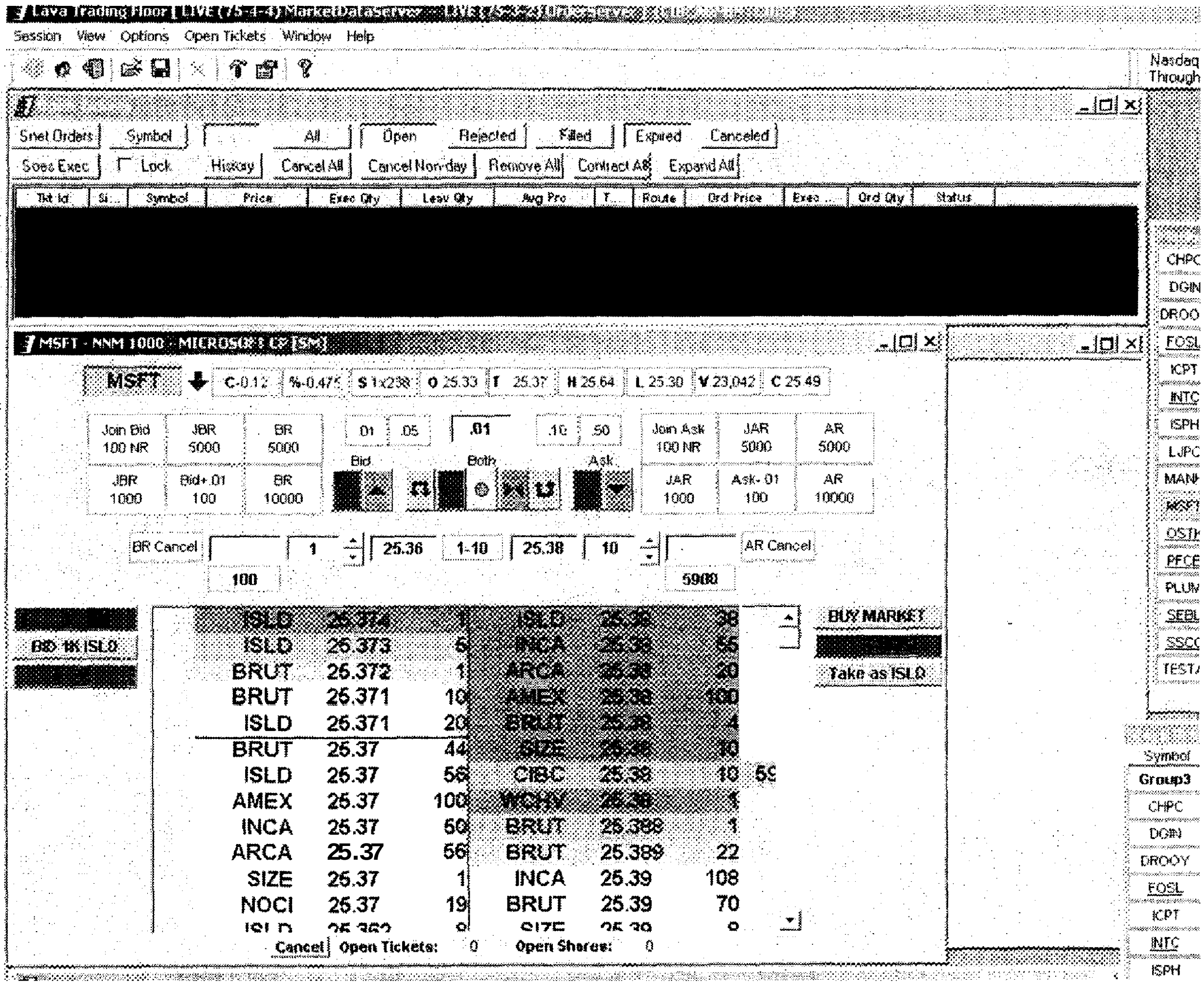
- *Market Centers*. Nasdaq accepts quotes in penny increments and orders in sub-penny increments up to four decimal places, but it truncates their **prices** to two decimal places and does not rank or display them by sub-pennies. Nasdaq's SuperMontage trading platform does not execute or display quotes and orders in sub-pennies, although firms that **accept** orders delivered in penny increments (as opposed to accepting automatic executions) can respond to those orders by offering sub-penny price improvement. Nasdaq's ACT system accepts trade reports in up to **six** decimal places to reflect its market participants' trading behavior. Archipelago, like Nasdaq, truncates orders received in sub-pennies and executes in penny amounts. Other UTP exchanges display quotations in penny increments, but allow trade reporting in sub-penny increments.

- *Exclusive SIPs*. Nasdaq, as the exclusive SIP for the Nasdaq UTF Plan, collects quotations up to four decimal places but disseminates those quotes in pennies only, and it accepts trade reports in up to eight decimal places. The Securities Industry Automation Corporation ("SIAC"), the **exclusive** SIP for the Consolidated Quote/Consolidated Tape Plans, accepts and disseminates quotes in pennies and trade reports in up to six decimal places. **As** a result, none of the sub-penny quotations that are entered into ECNs' systems are displayed in the NBBO.

- *Routing Systems*. **LAVA** and PowerNet, two popular order routing services, rank and display quotes and orders in increments of up to four decimal places, creating 10,000 price points within a single dollar. Moreover, since LAVA and PowerNet collect quotation information from SROs and ECNs that **use** different quotation increments, the quotations displayed within those systems are not themselves uniform.

- *Market Data* ***Vendors.*** **All** major market data vendors provide quotation data in penny increments, including Reuters, Bridge, Bloomberg, and ILX. Among the online brokerage services and financial websites that provide data to public investors, **the** major firms also provide quotation data in penny increments.

The full impact of the disparities in quotation conventions becomes completely clear only when **one** views the quotation montage that different market data vendors generate. For **example,** the graphic below illustrates **a** quote montage that includes sub-penny **prices** for Microsoft. The bid side of the market has several sub-penny prices available, **up** to 4/10ths of a penny better than the National Best Bid upon which retail investors base their investment decisions.



The use of sub-penny prices that are not displayed in the national montage is part of the market today. Participants use sub-penny orders, but the market data displays to the penny. **As** a consequence, hidden markets exist to which individual investors do not have access. Similarly, many retail investors do not have the ability to enter sub-penny orders. This creates a tiered market in which professional investors use sub-penny prices to gain priority over individual investors' orders for economically insignificant amounts.

Professional Traders May "Step Ahead" of Public Investors by Using Sub-Penny Quotations

The Commission has routinely stated that one trader must make an economically meaningful contribution to the price of a security in order to gain priority over another trader.[5] Today, however, some participants use sub-penny increments to "step-ahead" of displayed quotes and limit orders for an economically meaningless amount thereby devaluing price priority and reducing the incentive for aggressive quoting. For example, if the national **best** bid in Microsoft is 25.12, one trader might enter an order to buy 100 shares at 25.121 (Order **A)** and another to buy 100 shares at 25.1211 (Order B). **A** system programmed to route orders according to sub-penny rankings, such as **LAVA,** would cause Order B to be executed before Order **A,** and both to **be** executed before the national best bid. For a trade with a total dollar value of $2,512, Order B would gain priority over the best bid for 11 cents and it would gain priority over Order **A** for just 1 cent.

Nasdaq believes that some market participants are deliberately using sub-penny quotations, both at the 3^{rd} and 4^{th} decimal place, to gain priority over other orders rather than to contribute to legitimate price discovery. In March of 2003, Nasdaq analyzed sub-penny quotation and discovered that 37 percent of sub-penny quotes at the 3^{rd} decimal point occur at the $.001 or $.009 price points, and 43 percent of sub-penny quotes at the 4^{th} decimal point occur at the $.0001 or $.0009 price points. These figures are statistically significant indicators that participants are using **sub-penny** quotes to gain priority over other orders for **the** smallest amount possible, even if one would not expect a random distribution of price points due to mid-point pricing systems and other variables.[6]

This behavior directly impacts NASD IM-2110-2, the so-called Manning interpretation, which is designed to ensure that broker/dealers protect their customer limit orders. NASD's Manning Interpretation requires **NASD** member firms to provide a minimum level of price improvement to incoming orders in NMS and SmallCap securities if the firm chooses to trade **as** principal with those incoming orders at prices superior to customer limit orders they currently hold. If a **firm** fails to provide the minimum level of price improvement to the incoming order, the **firm** must execute its held customer limit orders. Generally, if **a** firm fails to provide the requisite amount of price improvement and also fails to execute its held customer limit orders, it is in violation of the Manning interpretation.

The Manning interpretation currently requires price improvement in penny increments whenever a market maker wished to trade proprietarily in front of its held customer limit orders without triggering an obligation to also execute those orders:

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5 *See* Exchange **Act** Release No. 44568 (July 18.2001).

6 According to data compiled and analyzed by Nasdaq's Economic Research department.

1) For customer limit orders priced **at or inside** the **best** inside market displayed in Nasdaq, the minimum amount of price improvement required is $0.01; and

2) For customer limit orders priced **outside** the best inside market displayed in Nasdaq, the market maker must price improve the incoming order by executing the incoming **order** at a price **at** least equal to the next superior minimum quotation increment in Nasdaq (currently $0.01).

Requiring price improvement in penny increments protects investors in the decimalized environment created by Congress and the Commission. **As** stated above, however, Nasdaq believes that sub-penny price improvement standard does not adequately protect investors, particularly where investors are not aware that sub-penny quotes even exist. For most orders, the aggregate cost of sub-penny price improvement is economically insignificant and could lead to increased order isolation, which the Commission has criticized in the past.[7]

Sub-Penny Quotation Undermines Best Execution and Short Sale Regulation

The transition to decimal quoting has complicated firms' ability to comply with their best execution obligations, and the current quoting environment of uneven increments exacerbates that problem. The duty of best execution requires that a broker/dealer **seek** to obtain for its customers' orders the most favorable terms reasonably available under the circumstances.[8] In any transaction for or with a customer, a **firm** must use reasonable diligence to ascertain the best inter-dealer market for a security and buy or sell in such market so that the price to the customer is as favorable as possible under prevailing market conditions.[9]

The lack of **a** uniform MPV means that quoting, trading and order routing practices are changing rapidly, making it difficult for firms to conduct a regular and rigorous review of their order routing practices. Depending upon the particular facts and circumstances surrounding an execution, actions that in one instance meet a firm'sbest execution obligation may not satisfy that obligation under another set of circumstances. The "scope of this duty of best execution must **evolve** as changes occur in the market that give rise to improved executions for customer orders, including opportunities to trade at more advantageous prices." [10] In the current environment, firms must continually assess whether firms are quoting in pennies or in sub-pennies, through what systems those quotes are reasonably accessible, whether **the** costs of those

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7 Exchange Act Release 42450 (Feb.23, 2000).

8 *See, e.g.,* **Newton** v. Merrill Lynch, Pierce, Fenner & Smith, Inc. 135 F.3d 266,270 (3d Cir. 1998) (en banc) (citation omitted), *cert. **denied** sub nom.* Merrill Lynch, Pierce, Fenner & **Smith** Inc. v. Kravitz, *525* **U.S. 81** 1 (1998).

9 *See* **NASD** Rule 2320.

10 Exchange Act Release 37619A **(Sept.** ***6*****, 1996).**

systems outweighs the benefits of a sub-penny price improvement, and myriad other, constantly changing variables.[11]

In fact, the **SEC** noted specifically that, "[p]rices superior to the public quote may at times be available in [Electronic Communications Networks (ECN(s)], even after adoption of the ECN [Rule], based, for example, on orders of institutional participants and others not covered by the ECN [Rule]. Superior prices also may be available in systems not classified **as** ECNs. . . . [W]here reliable, superior prices **are** readily accessible in such systems, broker-dealers should consider these prices in making decisions regarding the routing of customer orders."[12] The concern for market participants is that many systems where such superior prices reside are **less** accessible and involve higher costs for broker/dealers than do the public markets. Unless the Commission acts to impose a uniform MPV, these market inequities will only spread.

The use of penny quotes has also affected best execution obligations because decimalization dramatically increased instances of rapidly changing quotations, commonly referred to as "flickering" quotes. This phenomenon makes it difficult for firms to assess their best execution obligations because flickering quotes may not be reasonably available. The proliferation of sub-penny quotes has exacerbated the incidence of flickering quotes and Nasdaq believes that establishing **a** sub-penny MPV would make the problem of flickering quotes worse still.

The frequency of flickering quotes also complicates the administration of short sale regulations such as SEC Rule 10a-1 and NASD Rule 3350. The SEC Short Sale Rule uses the last sale price of a security to assess whether effecting a short **sale** is legal, while the NASD **rule** relies on the most recent bid change for that purpose. In today's penny quotation environment, where the best bid in the most active stocks can change multiple times each second, it is difficult to assess whether a short sale is legal or not, particularly in traditional, manual markets where execution **speeds** are slower than in automated electronic **markets.** Nasdaq anticipates that moving to sub-penny quotations will increase the occurrence of flickering quotes **because** each quotation will be that much less meaningful. Putting aside the question raised by some market participants of whether the rule is obsolete in a penny MPV environment, Nasdaq is concerned that the rule will be simply unmanageable in a sub-penny MPV environment.

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[11] As changes in the **market** occur, broker/dealers must analyze and modify their order execution procedures to consider price opportunities that become "reasonably available." ***Id.***

[12] SEC Rule 11Ac1-1(c)(5) requires **market** makers to publicly display limit orders that they place into ECNs that are priced better than their public quote, unless the ECN satisfies certain enumerated conditions.

A Sub-Penny MPV Would Reduce Depth And Liquidity With Little Offsetting Benefit

The transition to decimal pricing has contributed to the dramatic narrowing of the quoted and effective spreads in all securities. Nevertheless, the depth and liquidity in the market has suffered. Far fewer shares can be executed at the inside or even near the inside. Institutions have difficulty assessing depth at or near the NBBO and completing large orders. Fewer market makers offer execution guarantees at the inside and those that do guarantee fewer shares than before decimalization. Nasdaq is concerned that adopting a sub-penny MPV would further reduce market liquidity and depth without any economically meaningful offsetting reduction in quoted and effective spreads.

Sub-Penny Quotations Increase Market Participants' Overall Costs

The proliferation of sub-penny quotations and orders increases transaction costs for all market participants, market centers broker/dealers, market data vendors, mutual funds, and individual investors. For example, since the conversion to decimal pricing, Nasdaq has experienced a 263 percent increase in quotations. At the same time, Nasdaq has seen an 8.5 percent decrease in the number of trades and a 34 percent decrease in market volume. In addition to additional traffic and capacity costs, moving to sub-penny **prices** would entail substantial programming and other technical costs for Nasdaq. Capacity and programming costs would also be a serious concern of the **market** data vendor community.

Sub-penny trades increase the costs for member firms as well, including the costs associated with clearing trades. Sub-penny trading increases the number of confirmations associated with a particular trade, increasing NSCC clearing charges. Many firms' automated systems already have the capability to handle sub-pennies up to four-to-six decimal places; however, their systems would probably have to undergo a major redesign if sub-pennies are used beyond four-to-six decimal places, particularly with regard to screen display. Overall, these firms believe that sub-penny increments would have a significant, additional impact on trading systems and industry networks, including the affirmation and clearing systems. We believe that the consensus of member firms is that redesigning their systems and building up their capacity to accommodate sub-penny increments is possible from a technological standpoint, but that It would be impractical to do so and require considerable funds and staff time over the next few years with no real benefit to investors or contribution to market efficiency.

The Commission Should Act Now To Protect Investors

Although Nasdaq believes it is prudent to institute immediately **a** uniform quotation increment of one penny for quoting and trading Nasdaq securities, it cannot bring about this result on its own. Nor **can** it ignore that sub-penny trades currently account for 16 percent of all trades in Nasdaq securities. Therefore, Nasdaq **is** compelled to propose **a** sub-penny quotation increment on **its** market in order to remain competitive. That proposal is being filed simultaneously with this letter and, consistent with the **applicable** statutory procedures, we **respectfully** request prompt publication for notice and comment rulemaking.

The time **for** Commission action is now.

Sincerely,

Edward S. Knight

Edward S. Knight

EDWARD KNIGHT
EXECUTIVE VICE PRESIDENT

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August 4,2003

SR-11-03

BY HAND:

RECEIVED
AUG 05 2003
OFFICE OF THE SECRETARY

Katherine England, Esq.
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: SR-NASD-2003-121: Minimum Quotation Increment

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed herewith is the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Word 7.0 to facilitate production of the Federal Register.

If you have any questions, please contact Jeffrey S. Davis, Office of General Counsel, The Nasdaq Stock Market, Inc., at (202) 912-3035. The **fax** number of the Office of General Counsel is (202) 912-3199.

Very truly yours,

Edward S. Knight

Edward S. Knight

Attachrnent

File No. SR-NASD-2003-121
Consists **of 12** Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

Pursuant to the provisions ***of*** Section 19(b)(1) under the Securities Exchange Act of 1934 ("Act"), **NASD,** through its subsidiary The Nasdaq Stock Market, Inc. ("Nasdaq"), is herewith filing **a** proposed rule change to NASD Rule 4613 to adopt a $0.001 minimum quotation increment for Nasdaq securities. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

****

4613, Character of Quotations

(a) Two-sided Quotations

(1) **No Change.**

(A) No Change.

(B) **No Change.**

(C) **No Change.**

(D) Minimum Price Variation for Decimal-based Quotations

The minimum quotation increment for Nasdaq <u>National Market and SmallCap</u> securities [authorized for decimal pricing] shall be [$0.01] <u>$0.001</u>. Quotations failing to meet this standard shall be rejected.

(2) No Change.

(b) through (e) **No Change.**

****

2. Procedures of the Self-Regulatory Organization

The proposed rule was approved by the Board of Directors of Nasdaq at its meeting on May 7, 2003 and reviewed by the Board of Governors of the NASD at its meeting on May 8, 2003. The staff of Nasdaq has provided an opportunity for the staff of NASD Regulation, Inc. to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries. No further action by the **NASD** is required.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

On July 25, 2000, the NASD, jointly with other self-regulatory organizations, submitted and received SEC approval for a Decimals Implementation Plan for the Equities and Options Markets. **As** part of that plan, on July 29, 2002, Nasdaq permanently established **a** minimum quotation increment of $0.01 for Nasdaq National Market and SmallCap issues.[1] This proposal, if approved, will establish a minimum quotation increment of $0.001 for the display and dissemination of quotations in Nasdaq-listed securities. Decimal quotations submitted to Nasdaq that do not comport with the **sub-penny** minimum quotation increment standard will be rejected by Nasdaq systems.

Nasdaq notes that, simultaneous with filing this proposal, it has submitted a letter to the Commission urging the SEC to adopt a uniform rule requiring market participants to quote and trade Nasdaq securities in a consistent monetary increment.[2] Nasdaq believes that the existing quotation environment in which market participants use quotation increments ranging from pennies to hundredths of pennies harms investors by creating a two-tiered market, one for ordinary investors and another for professionals, undermining the operation of important Commission and self-regulatory organization rules and policies, reducing price competition,

1 Exchange Act Release 46280 (July 29, 2002); 67 FR 50739 (Aug. 5,2002).

2 *See* letter dated August 4, 2003, from Edward S. Knight, Executive Vice President and General Counsel, The Nasdaq Stock Market, Inc., to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission.

increasing trading costs, and reducing price competition.'

Although Nasdaq believes it is prudent to institute immediately **a** uniform quotation increment of one penny for quoting and trading Nasdaq securities, it cannot bring about this result on its own, Nor can it ignore that sub-penny trades currently account for 16% of **all** trades in Nasdaq securities. Some electronic communication networks and alternative trading systems accept, display and/or execute orders in sub-penny amounts. Several alternative trading systems such as POSIT also use sub-penny increments to match customer orders at the midpoint of the bid and ask quotation in stocks with a penny spread and also to report average price trades.

In the absence of Commission action on this issue, Nasdaq must implement **a** minimum quotation increment of $0.001 on its market in order to remain competitive. Nasdaq will not, however, change any rules that are designed to protect investors or the marketplace generally. For example, a $0.01 increment will continue to exist for compliance with NASD Rule 3350 and EM-2110-2 governing short sales and Manning compliance. In addition, Nasdaq market makers will continue to be subject to all currently applicable rules regarding firm quotations, locked and crossed markets, and limit order display and execution. In this manner, Nasdaq will continue to ensure a high quality marketplace for all market participants.

(b) Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A of the Act,[4] in general and with Section 15A(b)(6)[5] of the Act, in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable

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3 *Id.*

4 15 U.S.C. 78o-3.

5 15 U.S.C. 78o-3.

principals of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

4. <u>Self-Regulatory Organization's Statement on Burden on Coinpetition</u>

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the **Act.**

5. <u>Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others</u>

Written comments were neither solicited nor received.

6. <u>Extension of Time Period for Commission Action</u>

Nasdaq does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. <u>Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)</u>

Not applicable.

8. <u>Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission</u>

Not applicable.

9. <u>**Exhibits**</u>

1. Completed notice of proposed rule change for publication in the <u>Federal Register</u>.

Pursuant to the requirements of the Securities Exchange Act of 1934, Nasdaq has caused this filing to be signed on its behalf by the duly authorized undersigned.

THE NASDAQ STOCK MARKET, INC.

BY: Edward S. Knight
Edward S. Knight
Executive Vice President
and General Counsel

Date: August 4,2003

EXHIBIT 1

SECURITIES **AND** EXCHANGE COMMISSION

(Release No. 34- **[leave space]** ; File No. SR-NASD-2003-121)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to NASD Rule 4613 to **Adopt a** $0.001 Minimum Quotation Increment for Nasdaq Securities

August __, 2003

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),' and Rule 19b-4 thereunder: notice is hereby given that on August 4, 2003, NASD, through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF **SUBSTANCE** OF THE PROPOSED RULE CHANGE

Nasdaq is filing a proposed rule change to NASD Rule 4613 to adopt a $0.001 minimum quotation increment for Nasdaq securities. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

****

4613. Character of Quotations

(a) Two-sided Quotations

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1 15 U.S.C. 78s(b)(1)

2 17 CFR 240.19b-4

(1) **No Change.**

(A) No Change.

(B) **No Change.**

(C) **No Change.**

(D) Minimum Price Variation for Decimal-based Quotations

The minimum quotation increment for Nasdaq National Market and SmallCap securities [authorized for decimal pricing] shall be [$0.01] $0.001. Quotations failing to meet this standard shall be rejected.

(2) No Change.

(b) through (e) **No Change.**

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II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE **PROPOSED** RULE CHANGE

In its filing with the Commission, Nasdaq included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. Nasdaq has prepared summaries, set forth in Sections **(A),** (B), and (C) below, of **the** most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) Purpose

On July 25, 2000, the NASD, jointly with other self-regulatory organizations, submitted and received SEC approval for a Decimals Implementation Plan for the Equities and Options Markets. **As part** of that plan, on July 29, 2002, Nasdaq permanently established a minimum quotation increment of $0.01 for Nasdaq National Market and SmallCap issues.[3] This proposal, if approved, will establish a minimum quotation increment of $0.001 for the display and dissemination of quotations in Nasdaq-listed securities. Decimal quotations submitted to Nasdaq that do not comport with the sub-penny minimum quotation increment standard will be rejected by Nasdaq systems.

Nasdaq notes that, simultaneous with filing this proposal, it has submitted **a** letter to the Commission urging the SEC to adopt **a** uniform rule requiring market participants to quote and trade Nasdaq securities in a consistent monetary increment.' Nasdaq believes that the existing quotation environment in which market participants use quotation increments ranging from pennies to hundredths of pennies harms investors by creating a two-tiered market, one for ordinary investors and another for professionals, undermining the operation of important Commission and self-regulatory organization rules and policies, reducing price competition, increasing trading costs, and reducing price competition.[5]

Although Nasdaq believes it is prudent to institute immediately a uniform quotation increment of one penny for quoting and trading Nasdaq securities, it cannot bring about this result on its own. Nor can it ignore that sub-penny trades currently account for 16% of all trades in Nasdaq securities. Some electronic communication networks and alternative trading systems accept, display and/or execute orders in sub-penny amounts. Several alternative trading systems such as POSIT also use sub-pennies increments to match customer orders at the midpoint of the

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3 Exchange Act Release 46280 (July 29, 2002); 67 FR 50739 (Aug. 5,2002).

4 ***See*** letter dated August 4, 2003, from Edward S. Knight, Executive Vice President and General Counsel, The Nasdaq Stock Market, Inc., to Jonathan *G*. Katz, Secretary, US. Securities and Exchange Commission.

5 *Id.*

bid and ask quotation in stocks with a penny spread and also to report average price trades.

In the absence of Commission action on this issue, Nasdaq must implement **a** minimum quotation increment of $0.001 on its market in order to remain competitive. **Nasdaq** will not, however, change **any** rules that are designed to protect investors or the marketplace generally. For **example,** a $0.01 increment will continue to exist for compliance with NASD Rule 3350 and IM-2110-2 governing short sales and Manning compliance. In addition, Nasdaq market makers will continue to be subject to all currently applicable rules regarding **firm** quotations, locked and crossed markets, and limit order display and execution. In this manner, Nasdaq will continue to ensure a high quality marketplace for all market participants.

(2) Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A of the Act,[6] in general and with Section 15A(b)(6)[7] of the Act, in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principals of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, arid, in general, to protect investors and the public interest.

(B) Self-Regulatory Organization's Statement on Burden on Competition

Nasdaq does not believe that *the* proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as

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6 15 U.S.C. 78o-3.

7 15 U.S.C. 78o-3.

amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

€3. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to file number SR-NASD-2003-121, and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority![8]

Margaret H. McFarland

Deputy Secretary

Action **as** set forth or recommended herein
APPROVED pursuant to authority delegated by
the Commission under Public Law 87-592.

For the Division of Market Regulation

by:_______________________________

(DATE)

[8] 17 CFR 200.30-3(a)(12).