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March 20, 2003

Michael Corrao
Schwab Capital Markets
111 Pavonia Avenue East, 15th Floor
Jersey City, NJ 07310

Re: IM-4613 – Autoquoting Restrictions

Dear Mr. Corrao:

This letter responds to your letter, dated March 13, 2003, and discussions with staff of The Nasdaq Stock Market, Inc. ("Nasdaq"), wherein you request a determination that the computer generated quoting system ("CGQ") to be employed by Schwab Capital Markets L.P. ("Schwab") is consistent with NASD IM-4613, Nasdaq's policy prohibiting autoquoting and computer generated quoting, as those terms are defined in IM-4613.

On the basis of your letter and conversations with Nasdaq staff, we understand the facts to be as follows:

Schwab is a registered broker dealer providing over the counter execution services to over 200 broker-dealers. The firm is an affiliate of Charles Schwab & Co., Inc. with its primary offices located in Jersey City, New Jersey. Schwab makes markets in approximately 5,000 securities and has been a vocal proponent of automation in the securities industry.

In this regard, Schwab requests that Nasdaq issue an interpretive letter finding that the CGQ system to be utilized by Schwab, and described below, is consistent with IM-4613. In its letter, Schwab asserts that the CGQ system will allow Schwab to improve the marketplace by allowing the firm the ability to provide more liquidity to the marketplace when it is not otherwise available in the firm's limit order book. In addition, Schwab states that approval of its CGQ system also will allow it to better serve its customers by automatically representing customer buy or sell interest for market orders and limit orders that are not subject to display under SEC Rule 11Ac1-4 ("Limit Order Display Rule").

According to your letter, Schwab's proposed CGQ system will operate in the following manner:

- The CGQ system is designed to ensure that Schwab's quote will remain at certain pre-determined intervals in relation to the inside market. The system will adjust Schwab's quote based on an analysis of the current inside market prices, the price of Schwab's quote in relation to the inside market, and the prices of customer orders being held by Schwab in relation to the inside market. The CGQ system will not move Schwab's quote away from the inside market as the prices of the inside market approach Schwab's quote.

- Schwab will be capable of suspending or disabling its CGQ system upon a request from NASDAQ.

Response

In general, NASD IM-4613(c) defines Computer Generated Quoting as "the practice of effecting, without a physical entry, a quote update that is not designed to keep a market maker's quote away from the Nasdaq and/or national best bid/best offer."[1] Computer Generated Quoting is prohibited because the high quote traffic produced by these systems can have deleterious effect on Nasdaq's systems. However, if properly controlled and monitored, these system can contribute to market quality. Accordingly, paragraph (c)(3) of IM-4613 provides Nasdaq the authority to permit market makers to utilize CGQ systems under certain conditions. In establishing the conditions, Nasdaq must consider the market maker's impact on Nasdaq's capacity, in conjunction with the overall impact on Nasdaq's capacity of currently authorized CGQ systems. In addition, these conditions must be designed to protect investors and the public interest.

Your letter states that Schwab's system is designed to ensure that its quotes will remain at certain pre-determined intervals in relation to the inside market. The system will adjust Schwab's quotes based on an analysis of the current inside market prices, the prices of Schwab's quotes in relation to the inside market, and the prices of customer orders being held by Schwab in relation to the inside market. You also state that the CGQ system will not move Schwab's quotes away from the inside market as the prices of the inside market approach Schwab's quotes. Based on these assertions, Nasdaq finds that the described system complies with the definition of the term "Computer Generated Quoting."

Schwab is permitted to use the CGQ system described above, subject to the following conditions:

(1) Schwab will begin its CGQ activities starting with 500 Nasdaq securities that it will select in coordination with Nasdaq staff.

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[1] Excluded from the definition of Computer Generated Quoting are those autoquoting activities permitted under paragraph (b) of IM-4613.

Schwab will be permitted to expand the number of securities in which it employs its CGQ system only after consultation with Nasdaq. Expanding the number of securities must be consistent with Nasdaq's determination that there will be no material adverse impact on Nasdaq's system capacity;

(2) Schwab will provide Nasdaq, at all times, a current list of securities (in an electronic, ASCII text format) for which it is employing, or intends to employ, its CGQ system;

(3) Schwab will quote in a manner consistent with the autoquoting restriction set forth in Amendment 12 to the Nasdaq/UTP Plan, a copy of which is attached;

(4) From 9:30 a.m. to 9:35 a.m. Eastern Time and from 3:55 p.m. to 4:00 p.m. Eastern Time, Schwab's quote updates will not exceed the following parameters:
- 30 quotes per second in aggregate for all securities, measured over each 15 second interval; and
- a maximum of three quote updates per second for each security;

(5) From 9:35:01 a.m. to 3:54:59 p.m. Eastern Time, Schwab's quote updates will not exceed the following parameters:
- 50 quotes per second in aggregate for all securities, measured over each 15 second interval; and
- a maximum of three quote updates per second for each security;

(7)   Schwab must be able to suspend its CGQ system quickly upon request from Nasdaq; and

(8)   To demonstrate compliance with the parameters above, Schwab's system must measure quote update rates. Data concerning the quote update rates must be supplied to Nasdaq upon request.

The foregoing interpretive relief is limited to the specified period beginning on the date of this letter and ending on April 30, 2003, unless extended by Nasdaq in writing.

However, Nasdaq is implementing a pilot program during which market makers with approved CGQ systems can utilize their systems without any quote update limitations. The pilot program also is scheduled to expire at the close of business on April 30, 2003.

Specifically, during the pilot program, the following quote update limitations are <u>suspended</u>:

(1) From 9:30 a.m. to 9:35 a.m. Eastern Time and from 3:55 p.m. to 4:00 p.m. Eastern Time, Schwab's quote updates will not exceed the following parameters:
- 30 quotes per second in aggregate for all securities, measured over each 15 second interval; and
- a maximum of three quote updates per second for each security; and

(2) From 9:35:01 a.m. to 3:54:59 p.m. Eastern Time, Schwab's quote updates will not exceed the following parameters:
- 50 quotes per second in aggregate for all securities, measured over each 15 second interval; and
- a maximum of three quote updates per second for each security.

All other conditions contained in this letter remain in effect during the pilot period.

The pilot program will provide Nasdaq with useful information to help determine whether the quote update restrictions on CGQ systems can be modified or eliminated. Any decision in this regard must be consistent with Nasdaq's obligation to ensure the integrity of its systems and to protect investors and the public interest.

This interpretive relief and your inclusion in the pilot program are based solely on your representations and the facts that you presented to the staff, as well as Nasdaq's belief that providing Schwab with this interpretation will enhance market liquidity and serve the public interest. This interpretation is strictly limited to the application of NASD IM-4613 to Schwab's system described in this letter. In the event that any material change occurs with respect to any of those facts or representations, as they relate to NASD IM-4613, you should immediately inform Nasdaq staff.

The interpretive relief and the pilot program are subject to modification or revocation if at any time Nasdaq determines that such action is necessary or appropriate in furtherance of applicable laws or NASD rules. Moreover, the interpretation and the pilot program may be revoked or modified, if Nasdaq determines that Schwab's practices are having a material adverse impact on Nasdaq's systems capacity, such action is necessary for maintenance of fair and honest markets and the protection of investors, or that Schwab has not complied with any of the conditions described above. Nasdaq also may limit or terminate through its systems Schwab's ability to enter quotes in the manner described in this letter. As you know, Nasdaq and NASD monitor for compliance with the conditions contained in this interpretive relief.

The opinions expressed herein are staff opinions only and have not been reviewed or endorsed by the board of Directors of Nasdaq or NASD Regulation, or the Board of Governors of the NASD. This letter responds only to the issues that you have raised, based on the facts as described, and does not address any other rule or interpretation of the NASD, or other regulatory or legal issues.

If you have any questions, please feel free to call me at 202-912-3030, or Peter R. Geraghty, Associate Vice President and Associate General Counsel, at 202-912-3037.

Sincerely,

Edward S. Knight

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