



Edward S. Knight
Executive Vice President and General Counsel

June 10, 2002

Cameron Smith
General Counsel
Island Execution Services, LLC
50 Broad Street
New York, NY 10004

Re: IM-4613 – Autoquoting Restrictions

Dear Mr. Smith:

This letter responds to your letter, dated May 9, 2002, and discussions with staff of The Nasdaq Stock Market, Inc. (“Nasdaq”), wherein you request a determination that Island Execution Services’s (“Island Execution”) computer-generated quotation algorithm is consistent with NASD IM-4613, Nasdaq’s policy prohibiting autoquoting, as that term is defined in IM-4613.

We understand the facts to be as follows:

Island Execution is an NASD member approved to act as a market maker. Island Execution intends to make markets in Nasdaq and listed securities using a proprietary trading strategy that incorporates the use of computer-generated quotations. Specifically, Island Execution’s system will generate quotations based on orders displayed on the Island ECN.¹ Island Execution’s strategy will result in a substantial portion of its quotation updates being part of, or establishing, the National Best Bid or Offer in the security being quoted.

Island Execution states that it will be able to increase the amount of liquidity it provides to the marketplace if it is permitted to use its computer systems to generate quotations. Further, Island Execution commits that it will cooperate with Nasdaq in assessing the impact of its quotation activity on Nasdaq’s systems, and reduce its quotation traffic upon request. Island Execution also will increase gradually the number of securities in which it is a market maker to enable Nasdaq to monitor Island Execution’s impact on capacity.

Island Execution notes that IM-4613 sets out a general prohibition concerning auto-quoting. Nasdaq has concluded that this prohibition is necessary to offset the negative impact on the capacity and operation of the Nasdaq systems by certain auto-

¹ Island ECN also is an NASD member, which that operates an electronic communications network, as such term is defined in Rule 11Ac1-1(a)(8) under the Securities Exchange Act of 1934. Island Execution and Island ECN are affiliates.

quote techniques that generate quotes to keep a market maker's quote away from the best market. Island Execution further notes that since its system does not employ such techniques, Island Execution does not believe that the purpose of the Auto-Quote Policy would be applicable to its systems, and accordingly, seeks guidance with respect to the applicability of the policy. In particular Island Execution requests that, before it employs its computer generated quotation algorithm, Nasdaq confirm that its use (without any manual entries into the system) will not be deemed inconsistent with, or violative of, the Nasdaq "Auto-Quote Policy" set out in IM-4613.

Response

NASD IM-4613 states that, with certain exceptions, Nasdaq market makers are prohibited from using systems that effect automated quote updates or track inside quotations in Nasdaq. The purpose of the restriction is to "offset the negative impact on the capacity and operation of Nasdaq of certain autoquote techniques that track changes to the inside quotation in Nasdaq and automatically react by generating another quote to keep the market maker's quote away from the best market." As your letter notes, Island Execution's system does not employ techniques that track changes to the inside quotation in Nasdaq for the purpose of generating another quote to keep Island Execution's prevailing quote away from the best market.

Therefore, on the basis of your representations and the facts presented, Nasdaq's Office of the General Counsel believes it would be consistent with the NASD IM-4613 for Island Execution, as a Nasdaq market maker, to quote in the manner described in your letter as stated above, subject to the following conditions:

- (1) Island Execution's quoting algorithm is based on orders displayed on the Island ECN;
- (2) Island Execution's quoting algorithm does not employ techniques that track quote changes to the inside market for the purpose of generating quotes to keep Island Execution's prevailing quote away from the inside market, and the system is designed to result in Island Execution regularly participating at or near the best bid and offer;
- (3) Island Execution will phase in its computer-generated quoting activities starting with 10 Nasdaq securities that it will select in coordination with Nasdaq staff and will expand that number only after consultation with Nasdaq. Expanding the number of stocks must be consistent with Nasdaq's determination that there will be no material adverse impact on Nasdaq's system capacity;
- (4) Island Execution 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;

- (5) 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, Island Execution'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;
- (6) From 9:35:01 a.m. to 3:54:59 p.m. Eastern Time, Island Execution'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) Island Execution must be able to suspend its computer-generated quotation system quickly upon request from Nasdaq; and
- (8) To demonstrate compliance with the parameters above, Island Execution'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 the date before Nasdaq begins operating the Nasdaq Order Display Facility (commonly known as SuperMontage). The relief is based solely on your representations and the facts that you presented to the staff, as well as Nasdaq's belief that providing Island Execution 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 Island Execution'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.

This interpretive relief is 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 may be revoked or modified, if Nasdaq determines that Island Execution's computer-generated quotation 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 Island Execution has not complied with any of the conditions described above. Nasdaq also may limit or terminate Island Execution's ability to enter quotes in the manner described in this letter.

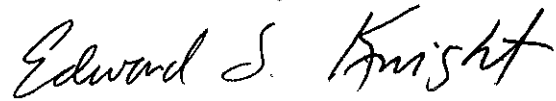
The opinions expressed herein are staff opinions only and have not been reviewed or endorsed by the board of Directors of Nasdaq or NASD Regulation, or the Board of Governors of the NASD. This letter responds only to the issues that you have raised,

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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 202-728-8212.

Sincerely,

A handwritten signature in black ink that reads "Edward S. Knight". The signature is written in a cursive style with a large, prominent "K".

Edward S. Knight

Attachment