



Edward S. Knight
Executive Vice President and General Counsel

June 10, 2002

Mr. Thomas Peterffy
Chairman
Timber Hill LLC
1 Pickwick Plaza
Greenwich, CT 06830

Re: IM 4613: Autoquoting Restriction

Dear Mr. Peterffy:

On November 14, 2001, staff of The Nasdaq Stock Market, Inc. ("Nasdaq") responded to your letter, also dated November 14th, concerning Timber Hill's computer-generated quotation algorithm and NASD Interpretive Material 4613, Nasdaq's policy concerning autoquoting. In its letter, staff indicated its belief that Timber Hill's use of the system described was consistent with IM 4613, subject to certain limitations and conditions. In addition, Nasdaq stated that its interpretation was subject modification.

As recently discussed with staff of Timber Hill, Nasdaq is modifying the conditions contained in the November 14th letter to ensure that computer-generated quotation algorithms such as Timber Hill's can be utilized in a manner consistent with, among other things, Nasdaq's capacity constraints and its obligation to maintain a fair and honest market and protect investors. This letter replaces in its entirety the letter dated November 14, 2001.

We understand the facts to be as follows:

Timber Hill is a technology-based market maker that, along with its affiliated companies, operates on over 40 exchanges and market centers in 16 countries worldwide. Timber Hill is registered with the Securities and Exchange Commission as a broker-dealer and is a member in good standing of the National Association of Securities Dealers, Chicago Board Options Exchange, American Stock Exchange, Philadelphia Stock Exchange, International Securities Exchange and Pacific Exchange.

Timber Hill's quotes are determined by a proprietary trading system that calculates and disseminates bids and offers bracketing the "most profitable price" for the products Timber Hill trades based on several factors, such as the last sale, bids, offers and sizes, where available, on stocks, futures and options on which Timber Hill receives this information, and certain statistically derived relationships among these factors. These prices are then modified by Timber Hill's system's tendency to hedge exposure in the most cost efficient manner. Timber Hill's systems do not employ techniques that track changes to the inside market for the purpose of generating quotes to keep Timber Hill's prevailing quote away from the inside market. Timber Hill's systems also are designed to result in Timber Hill regularly participating at or near the best bid and offer.

Timber Hill initially began quoting in 20 securities and increased that number in consultation with Nasdaq technology staff and in a manner consistent with Nasdaq's determination that such increase would not have a material adverse impact on Nasdaq system capacity. Timber Hill presently is a market maker in 404 securities.

Timber Hill notes that NASD IM-4613 sets out a general prohibition concerning autoquoting. Nasdaq has concluded that this prohibition is necessary to offset the negative impact on the capacity and operations of Nasdaq by certain autoquote techniques that generate quotes to keep a market maker's quotes away from the best market. Timber Hill notes that since its system does not employ such techniques, Timber Hill does not believe that the purpose of the autoquote policy would be applicable to Timber Hill's systems, and accordingly, Timber Hill seeks guidance with respect to the applicability of the policy. In particular, Timber Hill requests that Nasdaq confirm that using this system (without any manual entries to the system) will not be deemed inconsistent with, or violative, of the Nasdaq "Autoquote Policy" set out in NASD 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, Timber Hill's system does not employ techniques that track changes to the inside quotation in Nasdaq for the purpose of generating another quote to keep Timber Hill'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 Timber Hill, as a Nasdaq market maker, to quote in the manner described in your letter as stated above, subject to the following conditions:

- (1) Timber Hill's quoting algorithm is based on several factors, such as the last sale, bids, and offers (and associated sizes), where available, on stocks, futures and options on which Timber Hill receives this information, and certain statistically derived relationships among these factors;
- (2) Timber Hill's quoting algorithm does not employ techniques that track quote changes to the inside market for the purpose of generating quotes to keep Timber Hill's prevailing quote away from the inside market, and the system is designed to result in Timber Hill regularly participating at or near the best bid and offer;
- (3) In consultation with Nasdaq staff, Timber Hill can increase the number of securities in which it is a market maker. 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;
- (4) Timber Hill will quote in a manner consistent with the autot quoting 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, Timber Hill'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, Timber Hill'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) Timber Hill must be able to suspend its system quickly upon request from Nasdaq; and

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- (8) To demonstrate compliance with the parameters above, Timber Hill'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 Timber Hill 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 Timber Hill'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 Timber Hill'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 Timber Hill has not complied with any of the conditions described above. Nasdaq also may limit or terminate Timber Hill'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, 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,


Edward S. Knight

Attachment