



**A WHITE PAPER FROM
THE NASDAQ STOCK MARKET, INC.**

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Ensuring Competitive American Stock Markets

The American capital markets are the most vibrant and successful in the world. But their organization and governing structures are complex, uneven, and in need of modernization.

The Securities and Exchange Commission has recognized that market structure reform is long-overdue. The Commission has embarked on what we hope will be a thorough effort to examine how to make our markets better serve the interests of investors.

Since their inception, U.S. stock markets and exchanges have functioned largely as "self-regulating organizations." Reforming the rules that govern these "SROs" requires a system that is flexible, reflective of the changes ushered in by technology and most importantly, transparent.

NASDAQ believes that any market structure reform must, at the very least, address a core set of issues that remain at the heart of the debate about the future of American markets. These issues, summarized below, are the basis for creating a more competitive and transparent system.

Critical Issues for Reform:

Establish the highest governance standards for SROs

SRO's must be designed to prevent fraud and manipulation, to promote just and equitable principles of trade and to protect investors and the public interest. The governance structures of SRO's must also promote public confidence. NASDAQ believes that SROs should subject themselves to the same high standards of governance that the U.S. Congress and the SEC require of public companies. That includes complete compliance with public company disclosure rules and all relevant governance requirements under Sarbanes-Oxley.

Require SROs that operate market centers to establish a completely separate regulatory body

Because the risk of conflict of interest is always present in an SRO that operates a market center, NASDAQ believes that a commercial market center should not directly perform the regulatory functions associated with the trading activity within its market. The regulatory function should be separated by governance structure or by contract. NASDAQ itself has deliberately pursued this form of self-regulation, contracting with the NASD, with its separate staff, board and officers, to provide regulatory oversight of our marketplace.

Maintain full competition among market centers

In the current debate about market reform, some have suggested increasing order interaction by employing principles found only in a "central limit order book" – a single market center through which all trading activity must flow.

But in fact, the American investor benefits today from multiple, competing market centers. Congress has recognized these benefits and explicitly encouraged competition among market centers. In 1975, it instructed the SEC to establish a National Market System that not only resulted from competition among market centers but was intended to further encourage such competition. NASDAQ believes the SEC should continue to encourage competition among market centers thus satisfying the goals of the National Market System.

Repeal the Trade Through Rule to allow "best execution" for investors

The twenty year-old Trade Through Rule states that when a market receives an order, it cannot execute it at a price inferior to any found on another market. Although that sounds unobjectionable, in practice the rule restricts a broker's ability to meet its "best execution" obligations. Unlike twenty years ago where sophisticated routing and execution technology did not exist, investors today can choose between price, liquidity and speed. The Trade Through Rule prevents investors from having that choice. It forces investors to go through the slower, manual markets and, in doing so, protects those inefficient markets while increasing investors' opportunity costs resulting from delayed executions.

Apply the principles of Fair Disclosure Regulation to information shared on floor-based exchanges

Floor-based exchanges continue to permit practices that are inconsistent with investor protection principles of full transparency and

fair access. In many floor exchanges, information can flow freely between brokers and specialists that is not accessible to ordinary investors. Because this communication can be so crucial in establishing trading prices and trading strategies, it should be transparent and accessible to all or accessible to no one. The principles of the SEC Regulation Fair Disclosure would ensure that material, trading information shared on floor-based exchanges was made accessible to all market participants, large or small, or made accessible to no one.

Permit SROs to withdraw from the ITS plan and establish bilateral linkages among markets

The Intermarket Trading System Plan, first drafted in the 1970s, no longer serves the goals of the National Market System. Because it requires unanimous approval from each participating SRO for every new innovation by a single member, in practice it has become a barrier to competition and new developments. SROs should be permitted to withdraw from the ITS Plan and function through the establishment of effective bilateral relationships with other market centers. Modern market structure reform requires abandoning or thoroughly rewriting the provisions of the original ITS Plan.

Modify the formula for distribution of market data revenue

The National Market System and SEC rules required the creation of a consolidated quote and required the dissemination by vendors of the consolidated quote. As a result, the consolidated quote generates substantial revenues for market centers. However, the formula for distributing this market data revenue is based on transactions and fails to recognize the value of quotations. More troubling, the current formula can encourage improper trading activities.

NASDAQ believes the Commission should change the formula for the distribution of market data revenue to reward markets for their participation in the consolidated quote. In addition, with the introduction of decimalization, the consolidated quote has experienced some diminished value for investors. Decimalization requires market centers to display greater depth of information at multiple price levels. Market centers should have greater freedoms to create and disseminate their own unique market data. The SEC can encourage the creation of competitive and innovative market data products by clarifying a market's rights to disseminate unique market data content free of government intervention and restrictions.

The SEC must determine a uniform Minimum Price Variation (MPV) for trading equity securities

In 2001, the SEC requested comments on the effects of decimal trading in subpennies. Today, there continues to be a lack of uniformity with respect to minimum trading increments. As a result of this lack of uniformity, some investors are unable to see or access subpenny quotations because such increments are not reflected in the public quotations. NASDAQ urges the SEC to adopt a uniform rule requiring market participants to quote and trade securities in a consistent monetary increment or "minimum price variation" to ensure that all investors have access to equivalent information.

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