

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

In its filing with the Commission, the NASD 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. The NASD 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 24, 2002, the Commission approved SR-NASD-2002-97,⁴ which authorizes NASD to operate the ADF on a pilot basis for nine months, pending the anticipated approval of SR-NASD-2001-90,⁵ which proposes to operate the ADF on a permanent basis. As described in detail in SR-NASD-2001-90, the ADF is a quotation collection, trade comparison, and trade reporting facility developed by NASD in accordance with the Commission's SuperMontage Approval Order⁶ and in conjunction with Nasdaq's anticipated registration as a national securities exchange.⁷

For the duration of the pilot period, ADF will provide ADF market participants (market makers and ECNs) the ability to post quotations in Nasdaq securities and will provide all members that participate in the ADF the ability to view quotations and report transactions in Nasdaq securities to the Exclusive Securities Information Processor ("SIP") for Nasdaq-listed issues for consolidation and dissemination of data to vendors and ADF market participants. The facility also will provide for trade comparison through the Trade Reporting and Comparison Service ("TRACS"). This mechanism operates similarly to the trade reporting functions of Nasdaq's Automated Confirmation Transactions Service ("ACT").⁸

In SR-NASD-2002-97, NASD proposed the Rule 7000A Series, which provides the fee structure applicable to quotation and transaction-related activities through the ADF. Pursuant to that fee structure, NASD has not been charging ADF participants for transaction and quotation update fees (Rules 7010A(a) and (b), respectively) for a period of up to three months during the initial six months of operation of the ADF (from July 29, 2002 to January 29, 2003). Also during the first six-months of the ADF's operation, but subsequent to the three-month "no charge" period, ADF participants are eligible for certain volume discounts to make the overall cost of trade reporting and quoting through the ADF more attractive to higher volume users.

Given that the six-month "no charge/volume discount" fee structure is scheduled to end on January 29, 2003, NASD staff has been reviewing the ADF fee structure and now is proposing a new fee structure to commence on February 17, 2003. Specifically, NASD is proposing to eliminate trade reporting fees, browse/query and Automated Give-Up ("AGU")/NSCC Qualified Special Representative ("QSR") comparison charges (provided that the associated publicly disseminated trade is reported to the media through the ADF). With respect to "as of" trades, NASD is proposing to continue to charge \$0.30/side unless the "as of" trade is executed outside normal ADF operating hours of 8:00 a.m. to 6:30 p.m. and the member's daily average of publicly disseminated trades reported to the media through the ADF during the billing period is 150,000 or greater. NASD will continue to charge for corrective transactions. As a result, only the following TRACS-related fees will continue to apply: Comparison Fee of \$0.014/side per 100 shares (minimum 400 shares; maximum 7,500 shares); Late Report—T+N fee of \$0.30/side under the circumstances noted above; and Corrective Transaction Charge⁹ of \$0.25, paid by each party. AGU/QSR comparison charges of \$0.029/side would apply only if the associated trade is not reported to the ADF.

With respect to quotation activities, quotation update charges¹⁰ would vary depending on the number of publicly disseminated trades reported to the media through the ADF during normal ADF processing hours of 8:00 a.m. to

6:30 p.m. Specifically, quotation update charges would apply based on the average number of publicly disseminated trades reported to the media through the ADF per day during the billing period. If an ADF market participant's average trades reported to the media through the ADF per day during the billing period is less than one, the quotation charge applicable to that ADF market participant would be \$.02 per quotation update. Similarly, if an ADF market participant's average trades reported to the media through the ADF per day is between one and 150,000, the quotation charge applicable to that ADF market participant would be \$.01 per quotation update. Finally, if an ADF market participant's average trades reported to the media through the ADF per day during the billing period is greater than 150,000, no quotation update charges would apply.

The proposed fee structure also would provide for a certain number of quotation updates at no charge based on the average number of publicly disseminated trades reported to the media through the ADF per day during the billing period. Specifically, if an ADF Market Participant averages between one and 100,000 trades reported through the ADF per day, the market participant would receive five free quotes per trade during that billing period. If a market participant averages between 100,001 and 150,000 trades reported to the media through the ADF per day, it would receive 10 free quotes per trade during that billing period.

By imposing quotation fees based on the number of publicly disseminated trades reported to the media through the ADF, this fee structure will fairly impose costs on those members whose quotation activity creates system capacity demands, and therefore costs that are not covered by the revenue received from trades reported to the media through the ADF.

Members currently are charged a minimum of \$5,000 for installation costs associated with connecting to the ADF. The ADF, however, provides market participants with a credit of up to \$5,000 toward their trade reporting and comparison charges. Given the revised fee structure, NASD is proposing to amend Rule 7040A to permit the \$5,000 credit to be used toward any of the fees imposed under Rule 7010A(a) or (b), including quotation fees.

Finally, for administrative ease, NASD also is proposing to extend the current "no charge" period until February 14, 2003 and have the fee changes described herein commence February 17, 2003. As a result, ADF participants will continue not to be

⁴ Securities Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49822 (July 31, 2002).

⁵ Securities Exchange Act Release No. 45991 (May 28, 2002), 67 FR 39476 (June 7, 2002).

⁶ Securities Exchange Act Release No. 43863 (January 19, 2001), 66 FR 8020 (January 26, 2001) (File No. SR-NASD-99-53).

⁷ Securities Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001) (File No. 10-131).

⁸ TRACS does not perform risk management services that are provided by Nasdaq's ACT.

⁹ NASD also is proposing to add "Reversals" to the types of corrective transactions under Rule 7010A(a). Reversals are trade corrections made T+N.

¹⁰ A "quotation update" includes any change to the price or size of a displayed quotation.