June 30, 2004

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: Proposed Regulation NMS and Supplemental Request for Comment (File No. S7-10-04)

Dear Mr. Katz,

Introduction

Instinet Group Incorporated ("Instinet Group") appreciates the opportunity to provide the U.S. Securities and Exchange Commission ("Commission") with its comments on the Commission's proposed Regulation NMS and related rulemaking proposals (collectively, "the Proposals"), including comments on the issues raised in the Supplemental Request for Comment.[1] Instinet Group, through affiliates, is the largest global electronic agency securities broker and has been providing investors with electronic trading solutions and execution services for more than thirty years. We operate our two main businesses through Instinet, LLC, [2] and Inet ATS, Inc. ("INET").[3]

Instinet Group commends the Commission for proposing Regulation NMS thereby taking a critical step forward in the process of modernizing the regulation of the U.S. equity markets in light of the dramatic changes to the markets brought about by competition and technological advancements since the Commission's national market system ("NMS") regulations were first put into place in the 1970s.

In determining whether the Proposals, individually and collectively, advance the regulatory framework of the U.S. equity markets, Instinet Group believes that they should be assessed based on whether they further the interests of investors through the achievement of the five goals Congress sought to assure in directing the Commission to facilitate the development of the NMS: (1) efficient executions; (2) competition among different types of markets; (3) transparency of quotation and

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[1] Exchange Act Rel. Nos. 49325 (Feb. 26, 2004), 69 FR 11126 (Mar. 9, 2004) ("Proposing Release"); and 49749 (May 21, 2004) 69 FR 30141 (May 26, 2004) ("Supplemental Request for Comment").
[2] Instinet, the Institutional Broker, gives its customers the opportunity to use its sales-trading expertise and advanced technology tools to interact with global securities markets, improve trading and investment performance and lower overall trading costs. Instinet acts solely as an agent for its customers, including institutional investors, such as mutual funds, pension funds, insurance companies and hedge funds. Additional information regarding Instinet, LLC can be found at *http://www.instinet.com*.
[3] INET, the electronic marketplace, represents the consolidation of the order flow of the former Instinet ECN and former Island ECN, providing its U.S. broker-dealer customers one of the largest liquidity pools in Nasdaq-listed securities. Additional information regarding INET can be found at *http://www.inetats.com*.

trade information; (4) best execution of investors' orders; and (5) the opportunity of investor orders to interact without the participation of a dealer.[4]

Moreover, given the continuing rapid pace of change in the U.S. equity markets and the reality that the Commission is unlikely to soon again revisit the NMS regulatory framework on such a systemic basis, Instinet Group believes that the Proposals must be assessed not only on how they further Congress's goals for the NMS in the context of the realities of today's markets, but also on whether they are flexible enough to do so in the years to come given the certainty of further significant and unpredictable changes to the markets driven by competition and technology.

Instinet Group believes that the interests of investors and Congress's goals for the NMS are best advanced through a regulatory framework that establishes the basic "rules of the road" through the assurance of transparent and accessible markets, enabling fair competition among marketplaces that produces the highest quality, lowest cost, and most innovative markets for investors and market participants. At the same time, a regulatory framework that impedes marketplaces from competing freely to the greatest possible extent consistent with investor protection, whether through market interaction rules, fee restrictions, or other unwarranted restrictions on market participants' behavior, impairs market quality, raises costs, and stifles innovation.

Consequently, Instinet Group supports the adoption of those components of the Proposals that enhance market transparency and accessibility, namely the proposed trade-through rule, premised on the availability of an effective opt-out exception; the market access requirements for SROs and quoting market participants, with certain clarifications; the proposed revision to the Regulation ATS fair access requirement; and the various proposed revisions to the market data dissemination requirements.

Instinet Group does not believe that the Commission should adopt the other components of the proposals, as they would impede competition among marketplaces to the detriment of investors, specifically, the proposed maximum cap on market access fees; the restrictions on locked and crossed markets; the revised market data revenue allocation formula; and the prohibition on quoting in subpenny increments. Instinet Group believes that less intrusive, alternative regulatory approaches or continuing reliance on market forces would be sufficient to resolve issues the Commission seeks to address with these components of the Proposals.

[4] Section 11A(a) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. 78k-1(a).

Executive Summary

Proposed Trade-Through Rule

- Instinet Group supports the adoption of the proposed trade-through rule, conditioned on the inclusion of an effective opt-out exception in any final rule. We believe that this modest regulatory reform would significantly advance Congress's goals for the NMS, especially in the market for NYSE stocks, while preserving the current high level of performance of the market for Nasdaq stocks.

<u>Lessons from the Experience of the NYSE and Nasdaq Markets</u>

- Instinet Group fully shares the Commission's view of the importance of limit orders to the markets' price discovery process, but does not believe that any evidence supports the Commission's assertions that the lack of a trade-through rule discourages the placement of limit orders or the presence of one encourages their display.

- The available empirical evidence – the relative performance of the NYSE market and the Nasdaq market, markets with and without trade-through rules, respectively – suggests that a trade-through rule is not necessary to incent the display of limit orders and may actually discourage their use.
    - The Nasdaq market consistently has lower effective spreads and faster execution times than the NYSE market in S&P 500 stocks;
    - The Nasdaq market has less "slippage" in the trading of Nasdaq stocks than NYSE stocks; and
    - The Nasdaq market almost uniformly had tighter spreads and greater depth than the NYSE in an analysis we conducted of 10 matched pairs of comparable stocks.

- The divergent development of the Nasdaq and NYSE markets demonstrates that a rigid trade-through rule has undermined the evolution of a more competitive and innovative market structure. With the ITS trade-through rule, which has insulated the NYSE market from the operation of competitive forces, the NYSE market has badly trailed the Nasdaq market in the development and adoption of new technologies, to the detriment of investors.

- Consequently, we believe the available evidence clearly demonstrates that rigid trade-through rules impose incalculable costs on investors, in the form of impaired market quality, higher transaction costs, and lessened incentives for efficiency and innovation. Further, as the Commission admits, the proposal would result in substantial implementation, administrative, and enforcement costs for the markets.

<u>Why any "Fast" Market or Quote Exception Would Produce Bad Public Policy</u>

- Instinet Group strongly recommends against the adoption of any "fast" market or quote exception to the proposed trade-through rule. We believe such an exception would have significant adverse consequences for investors and the markets and would not be an acceptable substitute for an effective opt-out exception.

- A "fast" market or quote exception reduces a broker-dealer's best execution obligation to chasing after the best-priced "fast" market or quote. But whether a market or quote is "fast" or "slow" is only one determinant of value. Other determinants may warrant opting out by various market participants, consistent with their best execution obligations. These include, but are not limited to: the likelihood of receiving an execution, trust, quote transparency, trading features such as sweeping, undisplayed orders and reserve size, the cost of market access, slippage, pre- and post-trade anonymity, priority and precedence trading rules, error rates, clearly erroneous policies, and trading halt policies.

- The definition of "fast" will be arbitrarily determined based on the lowest common denominator solution that is acceptable to the most politically potent market participants. This introduces problems of market clearance, by preventing markets from efficiently moving to the true price level of a security.

- Defining "fast" will become a slippery slope forcing the Commission to regulate more and more aspects of market technology.

- Coupled with the prohibition on locked or crossed markets, any "fast" exception will incent markets to operate as slow as possible while still being considered "fast" in an effort to force other market participants to interact with their quotes, destroying further incentives for technological innovation among markets.

- Investor transaction costs will increase by slowing all markets down to the speed of the slowest participant by inhibiting trading strategies that narrow spreads and provide valuable liquidity to the marketplace.

- Rather than devising a regulatory regime governing technology, the Commission should refrain from imposing trade-through rules or, at a minimum, allow sophisticated investors to trade-through slower markets or quotes when they believe it is in their best interest to do so, even if that means they choose to trade-through for sub-second response times. The threat of sophisticated investors bypassing markets that do not serve their needs will be a far more effective and efficient means of disciplining markets than any trade-through rule or attempt to define what is "fast" enough.

<u>Revisions Necessary to Create a Truly Effective Opt-Out</u>

- To provide an effective opt-out that ensures investor protection, promotes investor choice, and fosters the adoption of more advanced technology, the Commission should revise the proposed exception as follows:
  - Define the term "sophisticated investor," who are those most likely to take advantage of the exception, to facilitate its administration and maximize the prophylactic effect of its informed consent requirement;
  - Clarify that a broker-dealer's receipt of an opt-out order type or opt-out instruction from a sophisticated investor would satisfy the informed consent requirement of the exception;
  - Enable sophisticated investors to provide broker-dealers with their informed consent to opting-out on a global basis;
  - Eliminate the requirement to provide the national best bid or offer at the time of execution of an opted-out order, or at a minimum, allow sophisticated investors to choose not to receive this information; and
  - Enable opted-out orders to lock or cross the market, consistent with the Commission's recognition that for electronic markets the display of a quote is a prerequisite to trading at that price.

Proposed Maximum Cap on Market Access Fees

- Instinet Group strongly believes that the Commission should not adopt the proposed cap on the maximum access fees that may be charged by broker-dealers and SROs, as such restrictions do not advance investor protection and impair Congress's goals for the NMS. The ability to charge transaction fees at prices determined by the market, not government fiat, is central to the ability of markets, particularly agency markets, to exist and enable investors to benefit from the valuable services they provide.

- Experience clearly demonstrates that competition among market centers has been effective in ensuring that market access fees do not impose any unnecessary burden on investors' access to NMS markets – the maximum market access fee charged by ECNs having declined 80% since 1996 – and that such competition continues unabated. In addition, to the extent the Commission has concerns with issues related to market access fees, those issues can be readily addressed with much less intrusive disclosure-based alternatives.

- Questions exist as to whether the Commission actually possesses the requisite statutory authority to impose the proposed cap on maximum market access fees. In addition, there are doubts that the proposed cap would stand up to judicial scrutiny under the Administrative Procedure Act, as the Commission has not provided an adequate basis for the need for such a cap and has provided no basis for the proposed level of such cap.

- If the Commission determines to proceed with the adoption of a maximum cap on market access fees, the Commission should eliminate the distinction between broker-dealers displaying attributed and unattributed orders. In addition, any such cap should be limited to a single accumulated fee limitation and set at no less than the current $0.003 per share level. These revisions would eliminate the current proposal's curious and unnecessary discrimination against market participants entering unattributed orders, reduce the potential for unintended consequences, and simplify the administration of any final rule.

Proposed Restrictions on Locked and Crossed Markets

- Instinet Group strongly opposes the adoption of the proposed rule restricting locked and crossed markets in NMS stocks as contrary to the interests of investors and the markets. Restricting locked and crossed markets impairs market transparency and efficiency, artificially widens spreads, and discourages investors from entering aggressively-priced limit orders.

- Conversely, allowing the display of locking and crossing quotes increases market transparency, reduces quoted spreads, and encourages investors to enter aggressively-priced limit orders. Locking and crossing quotes also provide important signals to the overall market as to potential issues regarding the accessibility and efficiency of the locked or crossed market.

- The asserted justifications for the proposed restriction, namely alleged concerns with the orderliness and efficiency of the markets or investor confusion, are purely speculative and are not supported by any available evidence. In addition, any legitimate issues regarding broker-dealers' best execution obligations during locked and crossed markets can be handled in a much less intrusive manner through Commission or SRO interpretive guidance.

Proposed Market Access Requirement

- Instinet Group believes that there is a strong public policy interest in ensuring that market participants have the ability to access, on reasonable and non-discriminatory terms, all publicly displayed interest in the NMS. Prior to taking action on the proposal, however, the Commission should clarify the meaning of its "unfairly discriminatory" standard and confirm that market participants continue to have the necessary flexibility to price their services appropriately.

Proposed Revision to Regulation ATS Fair Access Requirement

- Instinet Group supports the adoption of the proposed reduction of the volume threshold for the application of the fair access requirement of Regulation ATS to a particular security from 20 percent to five percent. Reducing the volume threshold would ensure equal regulation of, and a level competitive playing field among, all ATSs that are significant market centers in the NMS.

Proposed Market Data Revenue Allocation Formulas

- Instinet Group opposes the adoption of the proposed market data revenue allocation formula. The proposed formula fails to provide any appreciable benefits for investors or advance Congress's goals for the NMS. The proposed formula makes arbitrary judgments as to the value of market information that inevitably will produce significant gaming behavior, market distortions, and other, as yet unknown, unintended consequences. A more appropriate course of action for the Commission would be to consider discrete measures to address directly the market distortions it believes are created by the current formulas.

Proposed Revision to Market Data Dissemination Requirements

- Instinet Group generally favors the adoption of the proposed various proposed revisions to the Commission's rules relating to the independent dissemination of market data by SROs and their members outside an NMS Plan, but has several specific concerns regarding the proposed standards for such dissemination, particularly regarding the distinction between "core" and "non-core" data and its implications.

- Instinet Group favors the adoption of the revisions to the consolidation requirements of redesignated Rule 603, but questions the continued necessity of a formal consolidated display requirement.

- Instinet supports the creation of market data advisory subcommittees to the NMS Plans, but believes this proposal is no substitute for direct Commission action to address the ongoing conflicts of interest and competitive concerns inherent in the NYSE and Nasdaq's control of the Network processors.

Proposed Restrictions on Subpenny Quotations

- Instinet Group opposes the adoption of the proposed restrictions on subpenny quotations. Market forces, rather than government intervention, should determine the appropriate trading increment for a security. Market forces already have demonstrated their responsiveness, recently moving to largely limit subpenny quoting to securities priced under $1.00.

- If the Commission nevertheless decides to adopt a restriction on subpenny quoting, at a minimum, it should provide a specific exception for the Nasdaq-100 Index ("QQQ") and other

ETFs, given that their derivative nature uniquely lends these securities to subpenny quoting and trading, as demonstrated by the existence of an active subpenny market in QQQ. The Commission also should facilitate the process of obtaining exemptive relief from the prohibition.

I. Proposed Trade-Through Rule

The Commission is proposing to require broker-dealers and SROs that execute orders in NMS stocks (collectively, "order execution facilities") to establish and enforce policies and procedures reasonably designed to prevent the occurrence of a trade-through in their markets, absent a specific exemption. Of these exceptions, the two most significant are the opt-out exception and the automated order execution facility exception ("fast market exception").

The opt-out exception would enable broker-dealers or customers to provide informed consent on an order-by-order basis to the execution of their orders by an order execution facility without regard to better-priced bids or offers displayed on other markets.

The fast market exception would enable an order execution facility that provides an automated response to orders it receives for execution against its displayed quotation to trade through the best displayed bid or offer of a non-automated order execution facility up to a specified trade-through limit amount, which is based on the current trading price of the security. In the Supplemental Request for Comment, the Commission requested comment on whether the fast market exception should instead apply to quotes that are not immediately accessible through an automatic execution facility, rather than providing an overall exception for a non-automated order execution facility.

A. Investors are Best Served by a Regulatory Framework where Rules Require Transparent and Accessible Markets, but Do Not Mandate Market Interaction

The fundamental issue raised by the Commission's proposed trade-through rule is what type of regulatory "rules of the road" best serve Congress's goals for an NMS: those that simply require competing markets to be transparent and accessible or those that mandate how competing markets interact with one another?

In Instinet Group's view, the historical experience of the U.S. markets clearly demonstrates that when markets are transparent and accessible, and participants have the freedom to trade on the market of their choosing, the increased competition facilitates innovation, promotes price discovery, and reduces costs for investors. History just as clearly demonstrates that attempts to mandate how markets and market participants interact – whether through trade-through rules, off-board trading restrictions, or gentlemen's agreements – not only raise the types of issues with which we are now dealing, but stifle competition, which inhibits innovation, harms the price discovery process, and raises costs for investors.

The public policy benefits of rules requiring transparent and accessible markets over those requiring mandatory market interaction are nowhere more clearly demonstrated than in the divergent experience of the Nasdaq market and the NYSE market in the almost twenty-five years since the adoption of the ITS trade through rule for NYSE-listed stocks. In the absence of a trade-through rule, the Nasdaq market has transformed itself from a telephone-based dealer market to one composed of competing, highly efficient electronic marketplaces. Over this same period, the Nasdaq market clearly has fostered greater competition and innovation than the NYSE market – smart order routing, advanced front-end systems, ECNs, and complete and fully electronic audit trails – all emerged in the Nasdaq market. In contrast, the NYSE market continues as a monopoly, remaining relatively unchanged, with the NYSE continuing to rely on manual intermediation to a great degree in its trading process, while regional exchanges and third market makers largely exist to internalize orders at prices derived from NYSE prices.

1. Empirical Evidence of the Impact of a Trade-Through Rule on Market Quality: A Comparison of the Nasdaq and NYSE Markets

A comparison of market quality on the Nasdaq and NYSE markets demonstrates that the Nasdaq market generally performs better than the NYSE, particularly for larger securities. For example, the Commission's Exchange Act Rule 11Ac1-5 statistics show that the Nasdaq market consistently has significantly lower effective spreads, faster execution times, and greater likelihood of executing orders at the NBBO than the NYSE market in S&P 500 stocks. Moreover, Instinet Group's own experience shows that there is significantly more "slippage" in the trading of NYSE stocks on the NYSE than in the trading of Nasdaq stocks on INET. In addition, Instinet Group's comparison of ten matched pairs of high-capitalization Nasdaq and NYSE securities demonstrates that the Nasdaq stocks almost uniformly have narrower spreads and greater quoted depth at the inside market than their NYSE counterparts.

Nasdaq has lower effective spreads than the NYSE. Effective spread measures the actual spreads paid by investors whose orders are directed to a particular market center.[5] Lower effective spreads produce lower trading costs for investors. As Table I-A of Exhibit A indicates, the Commission's Rule 11Ac1-5 data for covered marketable orders during the period April 2003 to April 2004 show that for 12 out of the 13 months effective spreads were lower in Nasdaq stocks than NYSE stocks, with a monthly average of 1.29 cents for Nasdaq stocks and 1.90 cents for NYSE stocks.[6]

Nasdaq has faster execution times than the NYSE. Faster execution times allow investors more efficient access to the market and greater execution certainty. As Table I-B of Exhibit A indicates, Rule 11Ac1-5 data for covered marketable orders during the period April 2003 to April 2004 show that execution times uniformly were substantially faster in Nasdaq stocks than in NYSE

[5] Exchange Act Rule 11Ac1-5(a)(2), 17 C.F.R. 240.11Ac1-5(a)(2) (definition of effective spread).
[6] SEC Rule 11Ac1-5 data for covered marketable orders for months April 2003 – April 2004 (provided by Market Systems, Inc., calculation of monthly average performed by Instinet Group).

stocks, with a monthly average of 6.1 seconds for Nasdaq stocks versus 19.0 seconds for NYSE stocks.[7]

Nasdaq has significantly less "slippage" than the NYSE. Slippage measures the difference between the displayed price at the time an order is entered and its actual execution price. Slippage can result in orders receiving either a better price or a worse price than the displayed price at the time of order entry. . In February 2004, Instinet Group conducted an analysis of the relative slippage between market orders Instinet routed to the NYSE in NYSE-listed stocks and INET in Nasdaq-listed stocks. We found that the average overall slippage in NYSE stocks was 2.5 times greater than that in Nasdaq stocks traded on INET. Slippage also is in some ways a measure of liquidity and the accuracy of displayed quotations. The fact that less slippage is seen in Nasdaq stocks may suggest that there is greater displayed liquidity in Nasdaq stocks than NYSE stocks.

Moreover, as Table I-C of Exhibit A indicates, Rule 11Ac1-5 data for covered marketable orders in S&P 500 stocks during the period April 2003 to April 2004 show that orders in Nasdaq stocks uniformly were significantly more likely to be executed at the current NBBO than were orders in NYSE stocks, with a monthly average of 80.5% for Nasdaq stocks as compared to only 63.1% for NYSE stocks.[8]

Nasdaq stocks have narrower spreads and greater depth at the inside than comparable NYSE stocks. For March 2004, Instinet Group conducted an analysis of spreads and depth at the inside quote in 10 pairs of comparable high market capitalization Nasdaq and NYSE stocks. We found that in almost every instance, the Nasdaq stock had a narrower spread and greater depth at the inside than its NYSE counterpart.

2. Empirical Evidence Does Not Support the Commission's Assertions as to the Benefits of a Trade-Through Rule in Incenting the Display of Limit Orders

The Commission's justification for proposing a market-wide trade-through rule begins with the premise that "one of the most important goals of an NMS is the "encouragement of the display of limit orders, which provide the basis for all price discovery in the markets."[9] The Commission continues with the assertion that when trading occurs at prices inferior to displayed quotations, this could discourage the display of limit orders if market participants believe that their limit orders will be bypassed by executions in other markets at inferior prices. From this assertion, the Commission concludes that a trade-through rule may encourage market participants to use limit orders and to quote aggressively, with the possible added benefits of improving price discovery process, increasing liquidity and depth, and reducing the effects of market fragmentation by promoting market interaction.[10]

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[7] Id.
[8] Id.
[9] Proposing Release at 23 (Section III.B.2.).
[10] Id. at 23-24 (Section III.B.2.).

Instinet Group fully agrees with the Commission on the critical role of limit orders in promoting the price discovery process, and the benefits that flow to investors and market efficiency from a market structure that encourages the display of limit orders. However, we do not believe that a price protection rule such as the trade-through rule provides any significant incentive to encourage the display of limit orders by investors – notably, the Commission puts forth no evidence that the existing ITS trade-through rule provides such an incentive. This is a critical point, as many interested market participants have seized upon the argument that permitting trade-throughs to occur will simply enable sophisticated investors to ignore limit orders entered by institutional and retail investors, causing these investors to lose confidence in the markets and thereby post fewer limit orders.

There is simply no empirical evidence that we are aware of that the absence of a trade-through rule disincents investors from placing limit orders in Nasdaq stocks. Indeed, the Commission states in the Proposing Release that "[y]et, even without a trade-through rule, the Nasdaq market does not appear to lack competitive quoting in the most actively traded securities."[11]

Further, there is no credible evidence that investors place less limit orders in Nasdaq stocks per trading unit than they do in NYSE stocks. In fact, empirical and anecdotal evidence suggest just the opposite. The greater depth and tighter spreads in comparable Nasdaq versus NYSE stocks and the lower slippage overall in Nasdaq versus NYSE stocks all suggest that investors and market participants place more limit orders in Nasdaq stocks than NYSE stocks. Moreover, anecdotal evidence from numerous informal conversations we have had with market participants supports this view as well – market participants are far more reluctant to place limit orders on the NYSE floor than in an electronic market trading Nasdaq stocks.

Even if we were prepared to make the leap of faith that the ability to trade through creates a disincentive for investors to place limit orders, price matching (i.e., executing orders at the displayed national best bid and offer ("NBBO") price while leaving the limit orders representing the NBBO unexecuted) would still be even more harmful as it occurs much more frequently than do trade-throughs, but the Commission is not proposing to proscribe price matching.[12] Such a result would appear to be arbitrary and capricious regulation. It follows that there is a simple choice for the Commission to make between two regulatory alternatives – impose no price/time priority across

[11] Id. at 34 (Section III.B.2.c.).
[12] For example, assume the displayed NBBO is 19.99 bid and 20.01 offered. An investor submits a limit order to buy at $20.00, improving the NBBO to 20.00 – 20.01, bid and offered. If a trade-through rule is in effect, no market participant could trade at a price less than $20.00 without first attempting to execute against the $20.00 bid. But because a price priority regime such as a trade-through rule does not provide time priority to orders, any market participant can engage in price matching by trading at $20.00 without executing against the investor's $20.00 bid. The investor is just as harmed as if a trade-through had occurred, as he or she is providing valuable price information to the market, but is left watching while other market participants free ride off of the information by executing orders at the price of his or her order. Note that such "price matching" behavior could not occur under a price/time priority regime. If a price/time priority rule applied across NMS markets, no other market participant could execute an order at $20.00 until they first traded with the order of the customer than posted the $20.00 bid.

markets or strict price/time priority across markets.[13] The adoption of the proposed trade-through rule would achieve the benefits of neither alternative, rather it represents a Solomonic attempt to split the baby.

In the current market environment with penny increments, transparency and electronic, nearly frictionless access to markets, the empirical evidence strongly suggests that trade-through restrictions between market centers provide no positive incentives to the placement of limit orders by investors while at the same time creating gaming opportunities for market participants to publish quotes that actually impair price discovery, increase transaction costs, and delay and complicate efficient and beneficial market clearance across market centers.

3. The Established Value of Transparent and Accessible Markets and Best Execution Obligations in Incenting the Display of Limit Orders and Promoting Price Protection

The experience of electronic marketplaces in the Nasdaq market clearly establishes that requiring markets to be transparent and accessible, but allowing them to operate without market interaction rules, provides the necessary incentives for market participants to display limit orders. In addition, the superior performance of the Nasdaq market in the absence of a trade-through rule, as compared to that of the NYSE market with a trade-through rule, demonstrates that requiring transparency and access, rather than mandating market interaction, in fact is the best means of producing the benefits the Commission seeks to achieve with its proposed trade-through rule.

Through the adoption of the Order Handling Rules and Regulation ATS,[14] the Commission has fostered a regulatory regime that makes the best-priced orders of electronic marketplaces transparent and accessible to all market participants. In the intervening years, electronic marketplaces have emerged to become the predominant mechanisms for price discovery in the Nasdaq market. These electronic marketplaces – not only ATSs and ECNs, but Nasdaq SuperMontage, and the Archipelago Exchange – operate limit order books. As such, their success is completely dependent on investors' willingness to display limit orders on their systems. If the lack of a trade-through rule inhibits investors from displaying limit orders, how could electronic markets have achieved the overwhelming level of success they have in the Nasdaq market?

The answer is that a trade-through rule is not essential to incent market participants to display limit orders. Transparent, accessible, competing markets, coupled with broker-dealers' obligation to seek best execution for their customers' orders, offer a high level of synthetic price protection that is

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[13] We find it particularly ironic that specialists and market makers, who are among the most vocal advocates of the position that a trade–through rule is necessary to incent investors to display limit orders, are not demanding an end to price matching. The apparent reason why is that price matching is a basic component of their business models, whether effected through internalizing customer orders at the NBBO or, in the current parlance, providing an "outsource destination" that executes the orders of other broker-dealers and their customers at the NBBO.

[14] Exchange Act Rel. Nos. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) (Order Handling Rules Adopting Release); and 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998) (Regulation ATS Adopting Release).

sufficient to incent the display of limit orders without a necessity for a formal trade-through rule, and without the attendant negative consequences of such a rule.

In this regard, the duty of best execution obligates broker-dealers to seek the most advantageous terms reasonably available under the circumstances for a customer's transaction.[15] As price traditionally has been a predominant factor in the best execution equation, broker-dealers naturally will seek to interact with the best-priced orders displayed in the marketplace,[16] subject to their accessibility and the other factors commonly viewed as entering into a broker-dealer's best execution determination, including certainty of execution, speed of execution, price improvement opportunities available on other markets, cost of access, the size of the order, and the trading characteristics of the security.[17]

The empirical evidence supports our view that the operation of the duty of best execution synthetically promotes price protection across markets in a manner similar to that achieved through the imposition of a formal trade-through rule. Nasdaq's experience of low actual rates of trade-throughs, in the absence of a trade-through rule, demonstrates that market participants seek to execute orders at the best available prices consistent with their best execution obligations. We also assert that by allowing broker-dealers to exercise their judgment as to the relative accessibility of a particular market, markets trading Nasdaq stocks without a trade-through rule have an ongoing incentive to become more accessible and efficient, to the direct benefit of investors. This assertion is also borne out by experience – those markets trading Nasdaq stocks that are not made themselves truly accessible, whether by virtue of lack of connectivity, automation, or high transaction costs, have not been able to amass or retain any significant amount of market share.

B. The Adoption of a Trade-Through Rule Would Impose Significant Burdens on the Trading of All NMS Stocks

The unsubstantiated, purely speculative benefits of a trade-through rule must be balanced against the costs it will impose on investors and market efficiency. To reiterate, the Nasdaq market, without a trade-through rule, performs more efficiently and produces better prices than the NYSE

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[15] The duty of best execution derives from the common law agency duty of loyalty, which obligates an agent to act exclusively in the principal's best interest. Restatement 2d Agency §387 (1958). When a broker-dealer acts as agent on behalf of a customer in a transaction, the agent is under a duty to exercise reasonable care to obtain the most advantageous terms for a customer. Restatement 2d Agency §424 (1958). The duty applies whether a broker-dealer is acting as agent or principal. See E.F. Hutton & Co., Exchange Act Rel. No. 25887, 49 S.E.C. 829, 832 (1988); Opper v. Hancock, 250 F. Supp. 688, 673-74 (S.D.N.Y.), aff'd 367 F.2d 157 (2d Cir. 1966); Rule 2320(f), NASD Manual (CCH) (2004). See also Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc. 135 F.3d 266, 270-71 (3d Cir. 1998) (en banc)
[16] The Commission has stated that "[i]n its purest form, best execution can be thought of as executing a customer's order so that the customer's total cost or proceeds are the most favorable under the circumstances." Exchange Act. Rel. No. 34902 (Oct. 27, 1994), 59 FR 55006 (Payment for Order Flow Adopting Release). See also Newton, supra note 16, at 270. However, the Commission never has stated that a broker-dealer is bound exclusively by price considerations in satisfying its best execution obligations. See Order Handling Rules Adopting Release, supra note 14, at 162-63.
[17] See, e.g., SEC, Second Report on Bank Securities Activities, at 97-98, n.233, as reprinted in H.R. Rep. No. 145, 95 Cong., 1st Sess. 233 (Comm. Print 1977) and Exchange Act Rel. No. 43590 (Nov. 17, 2000), 65 FR 75413, 75418-19 (Dec. 1, 2000) (File No. S7-16-00) (Disclosure of Order Execution and Routing Practices Adopting Release).

market. The competition facilitated by the absence of a trade-through rule has made the Nasdaq market the source of almost all the significant innovations in the U.S. equity markets over the past twenty-five years. The imposition of a trade-through rule could significantly impair the performance of the Nasdaq market, resulting in investors receiving worse prices for their orders, and impeding the flow of innovations from that market that have benefited the U.S. equity markets as a whole.

Moreover, the current ITS trade-through rule only requires that members of participant markets "should avoid initiating a trade-through" and allows those traded-through to obtain specific relief through a complaint-based system.[18] The proposed trade-through rule would require order execution facilities to establish procedures to reasonably prevent trade-throughs from occurring. The initial and ongoing compliance burdens in establishing such procedures and administering and enforcing the trade-through rule consequently would be substantially greater than under the current ITS trade-through rule. In the Proposing Release, the Commission acknowledges the difficulties inherent in administering a trade-through rule, citing for example that market participants will have to deal with a large number of "false-positive" and "false-negative" trade-throughs.[19] We note that the synthetic price protection afforded by the exercise of broker-dealers' duty of best execution comes without the substantial administrative and compliance burdens a formal trade-through rule would produce.[20]

As the costs of a trade-through rule are clearly apparent while its benefits at best speculative and actually contrary to the actual experience of the markets for Nasdaq and NYSE stocks, we firmly believe that investor protection and Congress's NMS goals would not be advanced, and in fact would be undermined, by the adoption of a trade-through rule, most particularly one that does not provide market participants with the ability to choose the market on which their orders are executed.

C. Instinet Group Supports the Adoption of the Proposed Trade-Through Rule Conditioned on the Inclusion of an Effective Opt-Out Exception

Setting aside the substantial burdens associated with implementing and administering a trade-through rule on an intermarket basis, Instinet Group believes that the Commission's proposed trade-through rule, conditioned on the availability of an effective opt-out exception, provides a progressive

[18] Plan for the Purpose of Creating and Operating an Intermarket Communications Linkage Pursuant to Section 11A(a)(3)(B) of the Securities Exchange Act of 1934, Exhibit B.
[19] Proposing Release at 35 (Section III.C.1).
[20] The SEC's preliminary estimate cites costs to the industry of over $246 million to implement the necessary policies and procedures to prevent trade-throughs (including $101 million in outsourced legal fees), with an additional $75.6 million annual compliance cost. The current informed consent disclosure requirement of the opt-out exception to the rule is estimated to cost $100 million to implement and $58.8 million to ensure compliance with annually, and the disclosure of the national best bid or offer in connection with an opted-out trade is expected to cost $193.6 million, with an annual compliance cost of $148.2 million. Proposing Release at 73-80 (Section III.G.4.). As we note in Section II.I., infra, we believe that clarifying the informed consent requirement and eliminating the national best bid or offer disclosure requirement of the opt-out exception would significantly reduce the cost to the industry of implementing and complying with the proposed rule.

compromise solution that simultaneously achieves the Commission's intended goal of reinforcing the principle of price protection across markets, while preserving a strong, continuing incentive for markets to become more competitive, efficient, and accessible in response to the current and future needs of investors and the markets by enabling informed investors to exercise choice as to the market in which their orders are executed.

By providing market participants the ability to exercise their judgment not to interact with particular markets, whether motivated by concerns regarding the market's accessibility, lack of responsiveness, cost, or other factors, the opt-out exception will provide a sufficient, ongoing incentive for markets to enhance their accessibility to the levels required by the marketplace so as to avoid being traded through on a systemic basis. Anecdotal evidence already exists that the opt-out will be successful in providing such an incentive. For example, the mere possibility of trade-through reform has prompted the NYSE to propose changes on a pilot basis to its Direct+ system to improve the accessibility of its displayed quotations,[21] and the subsequent publication of the Commission's trade-through proposal has prompted the NYSE to announce its intention to propose further changes to make its market even more accessible.[22]

Moreover, an opt-out exception fosters the Commission's statutory obligation under Section 11A of the Exchange Act to foster competition among different types of markets that allows different market models to emerge and compete. Without it, markets will be reduced to least common denominator standards. No one will be able to experiment effectively with a new market model because the trade-through rule always will favor the market that encourages the best-displayed quotes, regardless of whether such market actually delivers best execution. Investors and the markets are all better served by allowing market participants to pursue best execution unrestrained by an arbitrary requirement to pursue the best available quotation. While best available quotation and best execution will most often coincide, they will not always. An opt-out exception thus also facilitates a broker-dealer's obligation to achieve best execution

In addition, the opt-out exception is consistent with the promotion of the principal of price protection that is the primary motivation for the Commission's trade-through proposal. Some have raised the concern that the opt-out exception would undermine the very principle of price protection the Commission seeks to reinforce through the adoption of a trade-through rule. This concern is unfounded given the realities of broker-dealers' best execution obligations, the competition among markets that will be engendered by providing informed investors with choice, and the Nasdaq market's long experience without a trade-through rule.

As discussed earlier, the duty of best execution obligates broker-dealers to seek out the best reasonably available terms for their customers' orders, with price being a predominant factor.[23] As

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[21] File No. SR-NYSE-2004-05 (Feb. 6, 2004) (proposed rule change to adopt NYSE Rule 1006 on a pilot basis).
[22] See Kate Kelly, NYSE's Automatic Transition, WALL ST. J., June 22, 2004, at C1; Kevin Drawbaugh and Javier David, "Scope of Fast-Moving NYSE Revamp Broadens – sources," Reuters, (Apr. 22, 2004) (quoting John Thain, CEO, NYSE).
[23] See supra notes 15-17 and accompanying text.

the Commission has made clear in the Proposing Release, the availability of an opt-out in no way changes a broker-dealer's best execution obligations.[24] Therefore, as long as prices are readily accessible, best available price will continue to be the primary factor in the overwhelming number of broker-dealers' order routing determinations.

Further, in requiring a broker-dealer to obtain a customer's informed consent prior to effecting an opt-out, the operation of the exception is limited to circumstances in which a customer believes that effecting an opt-out is in its own best interests. Therefore, the exception is appropriately structured to prevent its misuse by broker-dealers handling customer orders, particularly retail orders, and to limit its exercise to those instances that serve the policy objectives behind the exception.

D. The Importance of Encouraging Continually More Efficient Markets, or, Why Milliseconds Matter to Investors

A vitally important point to be made in connection with the opt-out exception is to correct the misperception of some that the market is already "too fast," and that continuing to improve response times to milliseconds is inconsequential to the great majority of investors and market participants.

It is absolutely necessary for the Commission to encourage market centers to provide continually faster, sub-second response times to handle potential future growth in the volume of trading in the NMS without creating or risking crippling latencies in the NMS. Hypothetically, if we assume that the U.S. equities markets continue to grow 10% per annum, half of the historical growth rates, we will see over one trillion shares traded annually by 2006.[25]

In addition, milliseconds do matter greatly to investors in today's markets. The reason that Nasdaq spreads are narrower than those on the NYSE and that greater liquidity is available on Nasdaq is because millisecond response times allow market participants to enter orders that narrow spreads. Milliseconds, which translate into the ability to control risk, allow market participants that provide liquidity to narrow the spreads for all investors. The faster liquidity providers can put in an order, cancel an order, or update an order, the more liquidity that they can enter into the marketplace and the narrower they can make the spread and still be profitable. For example, if it takes 10 seconds to cancel an order, by definition, a market participant will place a less aggressive limit order if it even decides to enter one at all. Making the market as efficient as possible facilitates the achievement of Congress's goals for the NMS, as it benefits almost every market participant, except for market intermediaries that believe they will be less profitable when spreads are narrower.

[24] Proposing Release at 35 (Section III.C.7.).
[25] See Exhibit B. A historical overview of the rolling five year compound annual growth rate (CAGR) for trading volumes in the U.S. equities markets (NYSE- and Nasdaq-listed stocks) for the years 1975 to 2003 produces a mean of 20.6%; a median of 22.8%; a high of 31.4%; and a low of 3.1%. Source: Meridian Securities.

E. The Need for an Effective Opt-Out Exception Is Even More Critical if the Commission Decides to Adopt a Fast Market or Quote Exception

Instinet Group is seriously concerned by a view expressed by certain participants in the Commission's hearings on Regulation NMS, and later echoed in statements attributed to the Commission in media reports, questioning the need for an effective opt-out exception if a "fast" market or quote exception is available.[26] To the contrary, we believe that the adoption of any "fast" market or quote exception would in fact increase the need for an effective opt-out exception.

Specifically, if the Commission does not provide an opt-out exception, the designation of "fast" market or quote confers enormous power on a market. No market participant will be able to bypass its quotation for any reason. Such power can and will be abused either directly (e.g., by quoting slower than executing orders) or indirectly (e.g., not investing in more than the minimum system capacity or redundancy).

In addition, an opt-out exception is necessary because "fast" and "slow" are not the only determinants of value. Other determinants, some of which go beyond those traditionally considered part of a broker-dealer's best execution evaluation, may warrant opting out by various market participants. These include, but are not limited to: the likelihood of execution, trust, quote transparency, trading features such as sweeping, undisplayed orders and reserve size, cost of accessing a particular market, slippage, pre- and post-trade anonymity, priority and precedence trading rules, error rates, clearly erroneous policies, and trading halt policies.

F. Any Attempt by the Commission to Adopt a Fast Market or Fast Quote Exception Would Be Unwise and Would Produce Seriously Negative Consequences for Investors and Market Participants

Instinet Group believes that the adoption of a "fast" market or quote exception would produce seriously negative consequences that would substantially outweigh any incremental value that their adoption sought to achieve. We also believe that a fast market or fast quote exception would be unnecessary with the availability of an effective opt-out exception.

We are concerned that in the process of attempting to craft a definition of what is a fast market that is acceptable to all markets – as realistically no market could allow its best-priced quotations to be systematically ignored – the resulting definition would necessarily be a compromised one, leading to a lowest common denominator solution. Such a result only would serve to codify the absolute minimum level of automation that floor-based markets already are well aware that they need to adopt to continue to be viable at this particular point in time. It would also

[26] See, e.g., Regulation NMS Hearing Transcript at 65, 78, and 85; Kevin Drawbaugh, "SEC Head – Opt-out on Best-Price May Not Be Needed," Reuters, (June 1, 2004) ("'The definition of a fast market is the speed of the availability of the quote,' [SEC Chairman] Donaldson said. 'If competition is on the basis of' quote speed, he said, 'do you need an opt-out?'").

lock in the status quo and provide no ongoing incentive for markets participating in the NMS to continue to improve their operations to become more accessible and efficient in response to competitive pressures and investor and market needs.

Retreating to a vague lowest common denominator solution would introduce real problems of market clearance in any regulatory regime where market participants were prohibited from locking and crossing slower markets that otherwise designate themselves as fast. Given the fact that a faster marketplace is forced to go to the slower marketplace, the incentive will be for marketplaces to be relatively slow (yet fast enough to be considered "fast") in order to force others to interact with it and a disincentive for markets to be relatively fast as they will be prevented by the trade-through rule and the locked and crossed market rule from displaying and/or trading at the next increment. Note that these rules ONLY punish the market attempting to move to the next trading increment without clearing other markets. The rule thus punishes the relatively faster market while rewarding the relatively slower market.

Any attempt to distinguish between "fast" and "slow" markets or quotes with a trade-through rule requires the Commission to precisely define acceptable system response times in order to avoid a race to the bottom (in this case a race to the slowest, fast market). At the same time, the Commission should expect that whatever response time ceilings it sets, given the gaming effects of trade-through, will become floors for the markets and will eliminate competition to develop faster systems in the future. This is very well likely to inhibit beneficial innovation and trading strategies that often narrow spreads, increase liquidity, and reduce transaction costs, and will almost certainly lead to system latencies during peak periods today, and bottlenecks and further latencies as volume grows in the future. In sum, this is an endeavor that will have profound negative unintended consequences for investors and the markets. It is unwise to specify response times, yet necessary, if the Commission is to insist on imposing intermarket trade-through rules.

The answer is not to refine the definition of "fast," it is to refrain from imposing trade-through rules, or at the very least, allow knowledgeable traders to trade-through slower markets when they believe it is in their best interest to do so, even if that means such traders chose to trade-through for sub-second response times. This threat of informed investors bypassing markets that do not serve their needs will be far more effective at disciplining markets than any trade-through rule or quixotic attempt to define what is "fast" enough.

G. Attempting to Develop the Necessary System Response Time Standards to Implement a "Fast" Market or Quote Exception Would Present the Commission with Issues of Statutory Authority and Expertise, and Would Subject It to Significant and Ongoing Administrative Burdens

In making the determination as to what are acceptable system response time standards required of any "fast" market or quote exception, Instinet Group believes that the Commission would take the determination as to what constitutes an accessible market out of the hands of those best situated to make that determination on an ongoing basis – the investors using such markets –

and instead impose a necessarily compromised standard on the market. As a result the Commission effectively would be imposing minimum market structure standards, which is inconsistent with the Commission's statutory role to facilitate the development of an NMS and not mandate the structure of the NMS or its participants.[27]

We are concerned that the Commission may not, and the proposed definition does not, appreciate the host of attributes market participants consider in weighing the relative level of accessibility of different market centers. Among others, these attributes include order entry times, order replacement times, and order cancellation times, (all under normal market conditions and severe market stress). We question whether the Commission, or any other entity for that matter, possesses the necessary expertise to make such judgments.

Finally, by establishing acceptable system response time standards to implement a "fast" market or quote exception, the Commission necessarily will be drawn into the exercise of ensuring that markets claiming "fast" market or quote status actually meet such standards, initially and on an ongoing basis, creating significant and unnecessary strains on limited Commission resources.

H. The Adoption of a Trade-Through Rule without An Opt-Out Exception Would Impair Investor Protection and the Achievement of Congress's Goals for the NMS

Instinet Group believes that the worst possible outcome for investors and the markets would be for the Commission to adopt a trade-through rule without an opt-out exception, even if it includes either a "fast" market or quote exception. Our view is that this outcome would provide no public policy benefit to investors or the markets, as it would fail to further the protection of limit orders in any significant way because price matching would be permitted, but would virtually eliminate intermarket competition by forcing operational and technological uniformity on each marketplace, negating price competition, system performance, or any other differentiating feature that a market may develop.

In this regard, as any "fast" market definition or automatic execution standards would be necessarily compromised so that they could be met by all markets, markets would lack ongoing incentives to improve their accessibility to meet the continually evolving needs of investors. The trade-through rule would operate to require market participants to route orders simply on the basis of whether a market is displaying the best available price at any moment in time, without the benefit of investors' informed judgment as to the true level of accessibility of the market or other factors legitimately considered by investors in determining where to route their orders, such as order response times – both during periods of normal and peak market activity, order fill rates, order cancellation times, the possibility of price improvement and disimprovement, the possibility of size improvement, and the cost of accessing particular markets.

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[27] Senate Comm. on Banking, Housing and Urban Affairs, Report to Accompany S.249, S.Rep. No. 94-75, 94th Cong., 1st Sess. (1975) ("Senate Report") at 7, 10 and House Comm. on Interstate & For. Com., Report to Accompany H.R. 4111, H. Rep. No. 94-123, 94th Cong., 1st. Sess., 50-51 (1975).

Ironically, adopting a trade-through rule with only a fast market or fast quote exception would collapse a broker-dealer's best execution obligation to a choice of "best" price vs. "speed," specifically the outcome that the opponents of trade-through reform have objected to all along – and one that the Commission itself has rejected previously.[28] "Speed" in this case, however, would be arbitrarily fixed by government mandate, rather than the evolving needs of investors and the markets. The end result would be to continue to disadvantage investors by artificially insulating the NYSE and other exchanges from a long overdue exposure to the continuing discipline of competition, while unnecessarily blunting the same competitive forces that have worked so successfully to increase the efficiency and accessibility of the markets trading Nasdaq stocks.

I. The Commission Needs to Make Certain Revisions to the Proposal to Create an Effective Opt-Out Exception that Benefits Investors

Instinet Group believes that certain revisions to the proposed opt-out exception are necessary to enable it to become a truly effective means of assuring that all markets participating in the NMS have a continuing incentive to improve their accessibility in response to the ever-evolving needs of investors and market participants.

1. Provide a Definition of Sophisticated Investor

Instinet Group believes that for purposes of the opt-out exception, the Commission should adopt a definition of a "sophisticated investor" that should include any broker-dealer, institutional investor, or active trader.[29] Coupled with our suggested clarification to the informed consent requirement and the elimination or limitation of the requirement to provide the national best bid or offer, the adoption of a sophisticated investor definition would facilitate the administration of the opt-out exception, reduce initial and ongoing compliance costs, and maximize the prophylactic effect of the informed consent requirement for less informed investors, such as retail investors.

2. Clarify How Broker-Dealers May Obtain Informed Consent from Sophisticated Investors.

Instinet Group strongly urges the Commission to clarify that broker-dealers will be considered to have obtained informed consent to an opt out from a sophisticated investor or another broker-dealer through the receipt of: (1) an opt-out order type specifically created for this purpose; or (2) an opt-out order handling instruction as part of the order entry process, including any instruction to execute an order on a particular market center. Without such clarification, broker-dealers will be required to establish and engage in unnecessary, costly, and time-consuming

[28] Disclosure of Order Execution and Routing Practices Adopting Release, supra note 17, at 65 FR 75418-19.

[29] For possible sources for elements of a sophisticated investor definition, see, e.g., Sections 3(a)(4) and (5) of the Exchange Act, 15 U.S.C. §78c(a)(4) and (5) (definitions of "broker" and "dealer"); Securities Act of 1933 Rule 144A(a)(1), 17 CFR 230.144A(a)(1) (definition of "qualified institutional buyer"); NASD Rule 3110(c)(4) (definition of "institutional account"); NASD Rule 2520(f)(8)(B) (definition of "day trading"); and NASD Rule 2360(e) (definition of "day trading strategy").

processes to obtain consent that already was clearly expressed, introducing delays in the exercise of an opt-out that unnecessarily would compromise the value of the exception.

3. Allow Sophisticated Investors to Provide Broker-Dealers with Consent on a Global Basis

To further streamline the process of effecting opt-outs and reduce attendant administrative burdens, Instinet Group believes that sophisticated investors should be permitted to enter into individual agreements with their broker-dealers to opt-out their orders from the trade-through rule on a global basis, absent contrary instructions from such investors at the time of entry of a particular order. Instinet Group believes allowing sophisticated investors to enter into appropriate global opt-out agreements would enable such investors to make use of the exception in the most efficient manner possible.

We believe that the Commission's reluctance to include a global opt-out stems from a general concern with the potential for the abuse of such agreements that is unwarranted in this context, particularly if the Commission revises the proposal to define a sophisticated investor for purposes of the exception, which would limit the availability of global agreements to sophisticated investors, and enables sophisticated investors to provide their broker-dealers with contrary instructions that would override such agreements at any time.

4. Allow Sophisticated Investors to Choose to Not to Receive the National Best Bid or Offer at the Time of Execution of their Opted Out Order

Instinet Group recommends that the Commission revise the proposal to eliminate the requirement that broker-dealers provide customers electing to opt out with the national best bid or offer at the time an opted-out order is executed. Customers who elect to opt out are extremely unlikely to have any use for this information. At a minimum, we believe that the Commission should enable sophisticated investors to choose to decline to receive this information, as such investors already have access to the information they need to assess the execution quality they receive. Eliminating this requirement or, at the very least, providing sophisticated investors with the ability to decline the receipt of this information, would reduce unnecessary burdens on investors and their broker-dealers.

5. Enable Opted-Out Orders to be Displayed at Prices that Would Lock or Cross the Publicly Displayed Quotes of Other Markets

Instinet Group appreciates the Commission's recognition in the Proposing Release that "for fully-electronic markets the ability to display a quote at a price is a prerequisite to trading at that price."[30] With this recognition, it should be evident to the Commission that for any opt-out

[30] Proposing Release at 128 (Section IV.B.4.).

exception to be meaningful for electronic markets, these markets must be able to display opt-out orders that would lock or cross the displayed quotes of other markets.

The Commission's provision of an opt-out exception without also providing opted-out orders the ability to lock or cross displayed quotes would encourage the growth of hidden, non-transparent markets, reduce order interaction among markets, and artificially increase spreads, as order execution facilities would only be able to utilize the exception by internalizing orders without displaying them to other market participants, turning otherwise displayable orders into undisplayed (i.e., "hidden") orders, or rounding their display prices so as to prevent a locked market.

For example, assume the current NBBO is 20.00 bid and 20.01 offered, the bid represented by Electronic Market A and the offer by Market B. If an investor enters an order to buy at 20.01 on Electronic Market A, that order could not be displayed at 20.01 if locked markets were prohibited. Electronic Market A would either need to convert the order into a hidden order or round the display price of the order down to 20.00. In either case, investors would be deprived of the informational value of such orders and the narrower spreads they would produce. By providing an opt-out exception that allows order execution facilities to display opted-out orders that would lock or cross other markets, however, the Commission would further the NMS goals of fostering open, transparent markets that encourage price discovery and order interaction, as such orders would be displayed in the public quotation system and accessible to other market participants.

II. Proposed Maximum Price Cap on Market Access Fees

A. Introduction

Proposed Rule 610(b) of Regulation NMS would impose a cap on the maximum fees that broker-dealers and SROs may charge for executing orders against their displayed quotations ("market access fees"). Specifically, Instinet Group's current understanding is that Rule 610(b) would provide that SROs and those broker-dealers that display attributable quotations through an SRO would be limited to charging a maximum $0.001 per share market access fee for the execution of orders against their displayed quotations that involve the use of an SRO order execution system. In addition, Rule 610(b) would limit the maximum market access fees that could be charged in any transaction to $0.002 per share. Consequently, ECNs and ATSs that charge market access fees would be limited to charging a maximum of $0.002 per share fee for executions of orders against their displayed quotations that are received through the ATS or ECN's proprietary systems.

Instinet Group strongly believes that the Commission should not adopt the proposed restrictions on the maximum market access fees that may be charged by broker-dealers and SROs, as such restrictions do not advance investor protection and impair Congress's goals for the NMS. The ability to charge transaction fees at prices determined by the market, not government fiat, is central to the ability of markets, particularly agency markets, to exist and enable investors to benefit from the services they provide. We believe that experience clearly demonstrates that competition among market centers has been effective in ensuring that market access fees do not impose any unnecessary burden on investors' access to NMS markets – the maximum market access fee charged by ECNs having declined 80% since 1996 – and that such competition continues unabated. In addition, to the extent the Commission has concerns with issues related to market access fees, we believe that those issues can be addressed with much less intrusive alternatives than by imposing a cap on such fees.

Further, Instinet Group questions whether the Commission actually possesses the requisite statutory authority to impose the proposed cap on maximum market access fees. In addition, we have doubts that the proposed cap would stand up to judicial scrutiny under the Administrative Procedure Act as the Commission has not provided an adequate basis for the need for such a cap and has provided no basis for the proposed level of such cap.

Finally, if the Commission determines to proceed with the adoption of a maximum cap on market access fees, Instinet Group recommends that the Commission should eliminate the proposed limitation on broker-dealers' ability to charge a market access fee to those broker-dealers that display an attributed quote, as the current approach would establish a meaningless distinction between equally valuable trading interest, and would only serve to raise the costs of market participants seeking anonymity for their orders. We further recommend that such a cap should be limited to a single accumulated fee limitation such as set forth in paragraph (b)(4) of proposed Rule 610. Doing so would reduce the potential for unintended consequences, and simplify its ongoing administration. As for an appropriate amount for such an accumulated fee limitation, Instinet Group believes that there is no basis for adopting any limitation other than at the existing $0.003 per share level, which was arrived at through open competition among marketplaces.

B. The Adoption of the Proposed Price Cap on Market Access Fees Would Not Serve Any Beneficial Public Policy Purpose

Instinet Group strongly believes that there is no public policy basis for the Commission to adopt the proposed restrictions on the maximum market access fees that can be charged by broker-dealers and SROs. The proposed restrictions would not advance investor protection and would seriously impair the achievement of Congress's NMS goals by interfering with the ability of markets, particularly agency markets, to continue to effectively compete in the NMS and provide the benefits of their services to investors.

The historical record all-too-clearly indicates that government-imposed price controls are simply bad public policy.[31] Government intervention, no matter how well intentioned, is no substitute for the judgment of the market as the best mechanism for setting the appropriate price for a good or service. There is absolutely no justification for government-imposed price caps where, as here, a very competitive marketplace exists for the good or service in question. With respect to market access fees, any government intervention in the market's price setting mechanism should

[31] Examples of government-imposed price controls widely recognized as failing to achieve their intended objectives but introducing serious distortions into the marketplace include: the 1971-1974 wage and price controls imposed by the Nixon administration; gasoline price ceilings established in 1973 and 1979; fixed commissions in the securities markets; and most recently, the caps on retail electricity prices that engendered the California power crisis of 2000-2001.

only be considered in the extreme situation where market access fees are not responsive to competitive forces and are demonstrably impeding market participants' access to NMS markets.

Here a robustly competitive market exists, making government action to cap fees completely unwarranted. Competition among market centers has been effective in ensuring that market access fees do not impose any unnecessary burdens on investors' ability to access quotations displayed by NMS markets, and that competition among markets continues to exert significant pressure on the market access fees currently charged. In the Nasdaq market, the four largest electronic marketplaces – Nasdaq's SuperMontage system, INET, Archipelago Exchange, and Brut ECN – currently all charge a maximum market access fee of $0.003 per share.[32] Compared to the $0.015 per share maximum market access fee once charged by Instinet, the only electronic market in existence at the time of the adoption of the Commission's Order Handling Rules, this represents an 80% decline over the last eight years in the maximum market access fees charged by electronic marketplaces.

Dramatic as this reduction may appear, it still underestimates the decline in the overall fees charged by electronic marketplaces in the same time period, given that Instinet's pricing model at the time of the Order Handling Rules was to charge its customers both for orders that added and removed liquidity, while the current pricing model in effect at the four largest electronic marketplaces provides customers a minimum $0.002 per share rebate for adding liquidity. Consequently, while the maximum overall fee charged by Instinet in 1996 for the purchase and sale of a stock was $0.03 ($0.015 + $0.015), the current maximum overall fee for purchasing and selling a stock is $0.001 (($0.002) + $0.003), representing a 96.6% reduction in maximum overall market access fees since 1996.

Competition among markets continues to lower market access fees. In Nasdaq stocks, most electronic marketplaces offer a variety of volume discount pricing arrangements to customers that add and/or take significant amounts of liquidity to a system. In addition, competitive forces have largely resolved the issue – magnified out of all consequence – that has driven much of the angst expressed by some market participants' over market access fees, that of the 'outlier ECNs.' Specifically, certain ECNs were able to extract economic rents by charging non-subscribers market access fees at levels significantly above those charged by the leading electronic markets (up to the $0.009 per share permitted by the Commission staff's ECN no-action letter position). These outlier ECNs accomplished this by either participating in SuperMontage, which did not allow Nasdaq members entering orders into the system to avoid interacting with the displayed quotations of these ECNs, or taking advantage of broker-dealers' belief that their best execution obligations required them to interact with the orders of such ECNs as the total transaction cost involved in accessing these ECNs (stock price plus market access fee) would still be lower than avoiding the quotes of such ECNs and trading at the next lower price level.

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[32] See, e.g., http://www.nasdaqtrader.com/tradingservices/productservices/pricesheet/pricing.stm#SM (Nasdaq market center fee schedule); http://tradearca.com (Archipelago Exchange fee schedule); http://www.inetats.com/prodserv/bd/fee/fee.asp (INET fee schedule).

Competitive forces have satisfactorily dealt with the issue of outlier ECNs. None of these ECNs has been able to attract any significant amount of market share, even by offering the largest liquidity rebates among electronic marketplaces, as market participants have put them at the bottom of their order routing tables, which means that orders placed on these ECNs would be the last to be executed at any price level, a position that no market participant wants to be in – either representing a customer order or trading for its own account. The price competition among other electronic markets also has made the excessive prices charged by these ECNs unsustainable.

The Commission's existing limited regulation of the prices ECNs can charge non-subscribers through the ECN no-action letter process, and its unintentional contribution in aggravating the outlier ECN issue, should serve as a cautionary tale of how price ceilings become price floors and themselves create distortions that interfere with the efficient pricing function of the market. In its first round of ECN no-action letters, the Commission staff limited ECNs to charging brokers accessing the ECN through an SRO what they charged "a substantial portion of their broker-dealer subscribers, and in any event, a maximum of $0.015 per share."[33] The result was that some ECNs charged the maximum $0.015 to non-subscribers, although these ECNs did not appear to generate any significant amount of internal order matching activity among their broker-dealer subscribers.

Consequently, in February 1999, the Commission staff changed the standard to no more than the fee that the ECN charges "a substantial portion of its *active* broker dealer subscribers, and in any event, no more than $0.015 per share."[34] (emphasis added) Subsequently, in October 2002, the Commission staff revised the maximum rate under this revised no-action letter standard to $0.009 per share, presumably to recognize the reduction in rates caused by competition among ECNs and other electronic marketplaces and the move to decimal pricing in the intervening years.[35] However, as competition continued to reduce the prices charged by electronic marketplaces to their current levels, the outlier ECNs continued to charge $0.009 per share, some part of which may have been due to the continuing use of this level in the Commission staff's no-action letters. Thus, the Commission should be wary of the market distortions that it could create through the substantially more far-reaching price regulation that would be imposed through the adoption of its market access fee proposal.

C. The Commission's Asserted Concerns with Market Access Fees Set Forth in the Proposing Release Do Not Warrant the Adoption of the Proposed Price Cap on Market Access Fees

In the Proposing Release, the Commission sets forth a number of apparent concerns with market access fees that are intended to justify the proposed restrictions on market access fees. Upon

[33] See, Letter from Richard R. Lindsey, Director, Division of Market Regulation, SEC, to Charles R. Hood, SVP and General Counsel, Instinet Corporation, dated Jan. 17, 1997.
[34] See, Letter from Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC, to Douglas M. Atkin, CEO, Instinet Corporation, dated Feb. 19, 1999.
[35] See, Letter from Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC, to Jon Kroeper, FVP, Regulatory Policy/Strategy, Instinet Corporation, dated Oct. 11, 2002.

closer examination, however, Instinet Group believes that these concerns, are either unfounded or are insufficient to warrant the adoption of the proposed cap on maximum access fees.

First, the Commission states that as ECNs and exchanges charge different market access fees that are not displayed in their published quotations, and market makers may not charge such fees as a result of the Commission's Quote Rule, "published quotes today do not reliably indicate the true prices that are actually available to investors" and "the absence of a uniform quoting convention has made it difficult for market participants to compare quotations readily across all marketplaces."[36] These concerns do not reflect the reality of the market. Market access fees are far from the only fees charged in connection with securities transactions that are not included in the public quotation – clearing charges, NASD regulatory fees, Commission Section 31 fees, brokerage commissions – are all among the fees investors are charged but that are not included in the public quotation. In fact, as market access fees are fees paid not by investors, but market participants handling investor orders, market access fees actually do not implicate "the true prices that are actually available to investors."[37]

As for the apparent difficulties of market participants in comparing quotations, market participants in fact are readily aware of the various market access fees charged by various marketplaces. Most ECNs, exchanges, and Nasdaq publish their fee schedules either on their websites, in their rules, or make them available upon request. As Nasdaq currently is the only means available for the public display of market makers' attributed quotations, market participants are well aware that the market access fee for interacting with a market maker quotation is Nasdaq's transaction fee. To the extent that the Commission is concerned with the lack of disclosure of market access fees, a much less intrusive solution to the 'problem' is to require market centers to disclose their fees – all fees – via the Internet. Another much less intrusive solution to the 'problem' would be to permit the use of subpenny quotations solely for the purpose of signifying the level of any market access fee charged in connection with executing against such quotation.

Second, the Commission states that because ECN quotes do not reflect market access fees, the NBBO somehow can be viewed as artificially narrow. As discussed above, ECN market access fees are subpenny fees in today's market, generally $0.003 per share in Nasdaq stocks and ETFs, currently lower for exchange-listed securities. The Commission must be consistent – either subpennies matter, or they do not. They cannot be immaterial for purposes of quoting increments and order priority but material when related to a market access fee.[38] Such an argument ignores the often-sizeable price improvement available on an ECN – either from an undisplayed order or a subpenny order rounded to the nearest penny for public display purposes. In addition, as discussed earlier, the prevalence of "slippage" on the NYSE – in which case a market participant has a significant chance of obtaining a worse price than is publicly displayed – indicates that the same issue with respect to an artificially narrow quote exists on the NYSE – a market that does not

[36] Proposing Release at 115 (Section IV.A.3.).
[37] Id.
[38] Compare with Proposing Release at 145 (Section V.5) (subpenning quoting might produce "marginally better prices" in securities priced over $1.00).

currently charge market access fees. And, in the case of the NYSE, the artificiality of the NBBO is of a greater degree of magnitude – measured in a penny increment, not the subpenny difference between the price with and without a subpenny ECN access fee.

Third, the Commission states that the liquidity rebates provided by ECNs, Nasdaq, Archipelago Exchange, and others to attract liquidity to their systems cause a "market distortion" by disadvantaging non-subscribers who cannot place limit orders on the systems, as the market access fees charged by non-subscribers act as a subsidy to the subscribers that place limit orders on the systems. The Commission adds that in an environment where penny spreads are commonplace, the differences in charges to non-subscribers and subscribers can be significant and raise fair access implications under the Order Handling Rules and Regulation ATS. This argument assumes that all subscribers place limit orders in equal or greater amounts to their taking of liquidity. The fact is that as many subscribers of these market centers are in fact largely net, or even purely, takers of liquidity, non-subscribers are not subsidizing their activities. As a result, non-subscribers are treated no differently in terms of market access fees charged than subscribers with similar trading behavior. In addition, the non-subscriber is not prevented from seeking to become a subscriber and avail itself of the order entry services of the ATS.[39]

Fourth, the Commission notes that the Quote Rule prohibits non-ECN broker-dealers from charging market access fees and adds that "many believe" this places non-ECN broker-dealers at an "unwarranted competitive disadvantage" to ECNs.[40] The Commission does recognize that Nasdaq's current pricing structure, which is quite similar to those of other marketplaces, effectively enables non-ECN broker-dealers, particularly market makers, to obtain access fees through their receipt of liquidity rebates, largely undercutting the Commission's argument. Moreover, we are not opposed in principle to allowing non-ECN/ATS broker-dealers to charge market access fees directly. However, to truly place ECN/ATS and non-ECN/ATS broker-dealers on a level competitive playing field, we believe that non-ECN/ATS broker-dealers that are permitted to directly charge market access fees also should be required to bear the obligations imposed on ATSs through Regulation ATS.

Fifth, and apparently foremost among the alleged "market distortions" attributed to market access fees, is the Commission's statement of the "view that the dramatic rise in locked and crossed markets in recent years can be traced to the proliferation of access fees, charges, and liquidity rebates offered by ECNs and Nasdaq."[41] In this view, users of market centers providing liquidity rebates

[39] Moreover, the Commission's reference to the "fair access" provisions of the Order Handling Rules and Regulation ATS is somewhat puzzling. Under the Order Handling Rules, an ECN must provide access to non-subscribers on terms, including fees, that are not 'designed to deter access', but does not contain a per se fair access standard. The fair access requirement of Regulation ATS applies to entities that are seeking to become subscribers to an ATS, which makes a discussion of non-subscriber rates in this context inapposite at best.

[40] Proposing Release at 121 (Section IV.B.3.a).

[41] Proposing Release at 116 (Section IV.A.3.). Contrary to the SEC's statement, the increase in locked and crossed markets in Nasdaq stocks is in fact directly attributable to three of the largest markets trading Nasdaq stocks discontinuing their quoting in the Nasdaq Stock Market in a six month period around the implementation of Nasdaq's competing SuperMontage system, which resulted in these markets no longer being subject to NASD Rule 4613(e), which

intentionally lock the displayed quotes of other markets to avoid paying a market access fee and collect a liquidity rebate. This view ignores the positive benefits of liquidity rebates – they encourage investors to place limit orders, which the Commission stated in the Proposing Release was one of the most important goals of the NMS. In balancing the public policy benefits of encouraging limit orders against an increase in locked and crossed markets, surely the positive benefits of liquidity rebates outweigh their supposed harmful impact. Indeed, we believe it is highly questionable that locked and crossed markets in isolation are harmful to the interests of investors and Congress's goals for the NMS. As discussed in Section III, infra, the ability to lock and cross markets provides various important benefits to investors and the markets.

D. The Proposed Restrictions on Market Access Fees Are Directly Inconsistent with Congress's Goals for the NMS

Instinet Group further believes that imposing the proposed caps on maximum market access fees is inconsistent with Congress's goals for the NMS in Section 11A of the Exchange Act in several specific ways. First, the proposed cap would not promote fair competition among different types of marketplaces as it would advantage dealer markets over agency markets.[42] The business model of dealer markets is structured around paying brokers for the opportunity to price match their customers' orders. Price matching occurs when a dealer disregards resting limit orders, instead executing orders at the prices of those resting limit orders on a principal basis, thus trading as principal against orders of other market participants, collecting the spread between the bid and offer, and obtaining principal trading profits. The proposed cap would not place any restrictions on the maximum fee dealers can charge for these activities, and would allow dealers to obtain a market access fee for orders that execute against their quotations through an SRO. Agency markets do not trade as principal, and neither collect spreads nor earn principal trading profits. The proposal would therefore provide dealer markets with a clearly substantial competitive advantage over agency markets.

In addition, the proposed cap would impair the opportunity for investors' orders to interact without the participation of a dealer by facilitating internalization.[43] Dealers internalize orders by trading as principal against orders of customers or other broker-dealers. Internalizing dealers replenish their inventories from selling stock as principal or lay off the risk they accrue through taking on principal positions by accessing trading interest on agency markets. Imposing the proposed cap on maximum access fees would artificially lower the cost of doing business for internalizers at the expense of agency markets, thus providing dealers with a regulatory subsidy that facilitates internalization.

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prohibits Nasdaq market participants from entering locking and crossing quotations on the Nasdaq system. Island began quoting on the National Stock Exchange, Inc. on August 8, 2002; Instinet began quoting on the NASD's Alternative Display Facility on October 10, 2002, and the Archipelago ECN began quoting Nasdaq stocks as the Archipelago Exchange on February 12, 2003.

[42] Section 11A(a)(1)(C)(ii) of the Exchange Act, 15 U.S.C.§78k-1(a)(1)(C)(ii).

[43] Section 11A(a)(1)(C)(v) of the Exchange Act, 15 U.S.C. §78k-1(a)(1)(C)(v).

Moreover, applying the logic that the Commission should cap any fees that in its opinion may produce "market distortions," it surely should follow that the Commission also should act to impose caps on the much more established and pervasive practice of dealers providing brokers payment for order flow, as the internalization facilitated by this practice disincents investors from entering limit orders, harms the public market's price discovery process, and inhibits order interaction on the NMS.

Further, as explained earlier in the context of the trade-through proposal, internalization discourages investors from entering limit orders into the market, as investor limit orders comprising the best price in the market remain unexecuted while internalized orders receive executions at the same price. Consequently, as a cap on market access fees facilitates internalization, it discourages investors from displaying limit orders, thus harming the price discovery process.

E. Instinet Group Questions whether the Commission Possesses the Requisite Statutory Authority to Adopt the Proposed Restrictions on Market Access Fees

Instinet Group seriously questions whether the Commission possesses the requisite statutory authority under the Exchange Act to adopt the proposed price cap on market access fees charged by broker-dealers (particularly ECNs and ATSs) and SROs.

1. The Exchange Act Does Not Provide the Commission with any Express Authority to Cap Market Access Fees

The express terms of the provisions of the Exchange Act applicable to the regulation of brokers, dealers, national securities exchanges, and national securities associations do not provide the Commission with the authority to limit or restrict the ability of broker-dealers and SROs to charge fully disclosed equitably allocated fees for services rendered to persons using their facilities.[44]

Section 15 of the Exchange Act governs the Commission's authority over the registration and regulation of broker-dealers. By its terms, Section 15 of the Exchange Act does not provide the Commission with any authority over the fees, commissions, or other charges assessed by broker-dealers.[45] Indeed, the only express prohibition on the fees broker-dealers may charge in the Exchange Act is a prohibition on their ability to solicit or accept referral fees from attorneys in

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[44] While members of an SRO arguably could be required to waive or limit their market access fees if they elect to participate in an SRO market on a voluntary basis pursuant to SRO rules waiving or limiting such fees, the proposed cap on market access fees is SEC, not SRO rulemaking. In this regard, we would not consider SEC rulemaking to achieve the same end indirectly to be a valid exercise of SEC authority, such as through an SEC rule that required SROs to adopt rules eliminating or restricting their members market access fees, or SEC rulemaking to amend an NMS Plan to cap or eliminate the market access fees of members of SROs (or the SROs themselves) participating in an NMS Plan. Further we believe that collective action on the part of SROs to restrict the ability of market participants to charge market access fees, such as are contained in the ITS Plan, raise serious competitive issues under the Exchange Act and federal anti-trust laws.
[45] Section 15 of the Exchange Act, 15 U.S.C. §78o.

assisting the representation of any persons in a private right of action under the Exchange Act or Securities Act of 1933.[46] Likewise, Section 11 of the Exchange Act, which provides the Commission with authority over the trading of securities by members of national securities exchanges, does not contain any express prohibitions on the fees, commissions, or other charges assessed by broker-dealers for their trading on exchanges.

With respect to SROs, Sections 6 and 15A of the Exchange Act govern the Commission's authority over registered national securities exchanges and national securities associations. Under these provisions, the Commission does not have the authority to limit or restrict the dues, fees, and other charges assessed by a registered national securities exchange or national securities association, as long as the rules of the exchange or association provide that such charges are allocated equitably among the persons using its facilities.[47]

Finally, Section 11A of the Exchange Act, which provides the Commission with its authority over the NMS, does not provide the Commission with any express authority over the fees, commissions or other charges assessed by broker-dealers or national securities exchanges or associations with respect to securities transactions.[48]

2. Congress Has Expressly Provided the Commission with Rate-Setting Authority When It Has Deemed such Authority Appropriate

In adopting the federal securities laws, Congress has given the Commission express rate-setting authority in other contexts where it has deemed such authority appropriate. For example, the Public Utility Holding Company Act of 1935 empowers the Commission to approve the price of interassociate sales of goods, and directs the Commission to price such goods "at cost, fairly and equitably allocated among [associate] companies."[49]

Moreover, as the Exchange Act does not permit national securities exchanges or national securities associations to "impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members," an attempt by the Commission to reduce or eliminate market access fees would appear to defy Congress's express aversion to rate-setting.[50] This would

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[46] Section 15(c)(8) of the Exchange Act, 15 U.S.C. §78(c)(8).
[47] Section 6(b)(4) of the Exchange Act, 15 U.S.C. §78f(b)(4) (national securities exchanges); Section 15A(b)(5) of the Exchange Act, 15 U.S.C. §78o-3(b)(5) (national securities associations).
[48] Section 11A of the Exchange Act, 15 U.S.C. §78k-1.
[49] Section 13(b) of the Public Utility Holding Company Act of 1935, 15 U.S.C. §79m(b). See also Sections 22(a) and (c) of the Investment Company Act of 1940, 15 U.S.C. §80a-22(a) and (c) (authorizing SEC to promulgate rules relating to minimum and maximum prices for purchase and sale of securities from an investment company) and Investment Company Act Rel. No. 26375A (Mar. 5, 2004), 68 FR 11762 (Mar. 5, 2004) (File No. S7-11-04) (proposed rulemaking to utilize authority under Sections 22(a) and (c) to impose a mandatory two percent redemption fee on the redemption of funds purchased within five days).
[50] Section 6(e)(1) of the Exchange Act, 15 U.S.C. §78f(e)(1) (national securities exchanges); Section 15A(b)(6) of the Exchange Act, 15 U.S.C. §78f(b)(6) (national securities associations).

particularly appear to apply with respect to the proposed cap on market access fees charged by broker-dealers for transactions with their customers.

Further, the absence of any authority for Commission rate-setting is confirmed by the lack of any statutory guidance as to how rates would be set or fixed, as well as the failure of the Exchange Act to give the Commission the necessary resources to develop the expertise necessary to perform such a function effectively.

3. Congress Did Not Provide the Commission with Authority to Fix, Set, or Otherwise Regulate the Level of Market Access Fees in Providing the Commission with Its Authority over the NMS

In mandating the establishment of the NMS in the 1975 Amendments to the Exchange Act, Congress did not authorize the Commission to limit or restrict the ability of broker-dealers and SROs to charge reasonable fees for order execution services rendered as a result of their participation in the NMS.[51]

The only authority that it appears that Congress granted to the Commission with respect to the terms of any service related to NMS is with respect to the provision of quotation and transaction information in NMS securities. In this regard, Section 11A(c)(1)(A) of the Exchange Act provides the Commission with the authority to assure that securities information processors ("SIPs") can obtain from exclusive SIPs information with respect to quotations and transactions in NMS securities on "fair and reasonable terms."[52] Section 11A(c)(1)(D) of the Exchange Act provides that broker-dealers, processors, and other persons can obtain quotation and transaction information in such securities from SIPs and SROs "on terms which are not unreasonably discriminatory."[53] We believe that a reasonable interpretation of the word "terms" used in these contexts would be to include as such terms the fees charged in connection with the provision of such information.

The absence of any such language in any other provision of Section 11A of the Exchange Act pertaining to market participants' other activities relating to NMS securities[54] or grants of authority to the Commission with respect to assuring the goals of the NMS are achieved, demonstrates that Congress did not provide the SEC with authority to limit the fees or other compensation that market participants – including broker-dealers and SROs – may receive in connection with providing the service of execution access to their quotes or orders in NMS securities.

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[51] See Securities Acts Amendments of 1975, Pub. L. No. 94-29 (the "1975 Amendments").
[52] Section 11A(c)(1)(A) of the Exchange Act, 15 U.S.C. §78k-1(c)(1)(A).
[53] Section 11A(c)(1)(D) of the Exchange Act, 15 U.S.C. §78k-1(c)(1)(D).
[54] See, e.g., Sections 11A(c)(1)(A), (B), and (F) of the Exchange Act, 15 U.S.C. §78k-1(c)(1)(A), (B), and (F) (authority over use of fraudulent quotation and transaction information; collection and processing of quotation and transaction information; equal regulation of all markets for NMS securities and market participants effecting transactions in such securities, respectively).

F. The Commission's Proposed Maximum Cap on Market Access Fees is Inconsistent with the Requirements of the Administrative Procedure Act

Instinet Group believes that the adoption of the proposed maximum cap on market access fees would be an arbitrary and capricious action that would not stand up to judicial scrutiny under the Administrative Procedure Act ("APA") as the Commission has not provided an adequate basis for the need for such caps and has provided no basis for the proposed level of such caps.[55]

1. The Commission Provides an Inadequate Basis for the Imposition of the Proposed Maximum Caps on Market Access Fees

Instinet Group believes that the adoption of the proposed maximum caps on market access fees would be arbitrary and capricious action as the Commission has not provided an adequate basis for their imposition that would survive judicial scrutiny under the APA. In the Proposing Release, the Commission asserts that market access fees "are currently causing various distortions in the trading of securities."[56] In Section II.C. above, we have examined each of these asserted 'distortions' in turn and clearly demonstrated that they are lacking the necessary empirical support to serve as bases for rulemaking.[57] The Commission also fails to adduce the necessary empirical evidence to support its claims that imposing a maximum cap on market access fees, particularly at a level lower than that currently charged by market participants charging such fees, would produce any benefits to markets or market participants, or outweigh the burdens such fees would impose on market participants charging such fees. The Commission also fails to consider the substantially less intrusive and narrowly-tailored disclosure-based solutions we have put forth earlier – the mandatory disclosure of market access fees via the Internet and the use of subpenny quotations to indicate the level of market access fees.

The Supplemental Request for Comment does not cure the failings of the Proposing Release. In this regard, the Commission limits its discussion of any rationale for the proposed caps to a brief mention that they are intended "to promote a common quoting convention" and "to facilitate the ready comparison of quotations across the NMS," but still does not provide any empirical support that these are issues that need to be addressed by rulemaking, would produce the asserted benefits, or outweigh the burdens that would be imposed on market participants.[58] This release also does not consider either of the substantially less intrusive disclosure-based alternative solutions we discussed above. Instead, the Supplemental Release presents alternatives that potentially are even more burdensome as they would replace a direct cap on maximum access fees with an indirect one, but one achieved by taking punitive measures against market participants that charge market access above a Commission-determined *de minimis* level – excluding such quotations from the allocation of

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[55] Section 706(2) of the APA, 5 U.S.C. §706(2).
[56] Proposing Release at 120 (Section IV.B.3.i.).
[57] See Timpinaro v. SEC, 2 F.3d 453, 458 (1993) (SEC did not adequately substantiate implicit claims in approving SRO rule).
[58] Supplemental Request for Comment at Section III.A.2.

market data revenues, allowing such quotations to be traded through or locked by quotations from market centers with de minimis fees.[59]

2. The Commission Provides No Basis for the Level of the Proposed Maximum Cap on Market Access Fees

Instinet Group believes that the proposed levels of the maximum caps on market access fees themselves are arbitrary and capricious and would not appear to stand up to judicial scrutiny under the APA as the Commission has provided absolutely no empirical (or for that matter any) basis in the Proposing Release or Supplemental Request for Comment for capping market access fees at such levels. The Commission has not held any public hearings, conducted any studies or analyses (that we are aware of), or cited any economic theory to determine 'appropriate' *de minimis* levels for market access fees. The Commission has not even put forward any explanation why its staff apparently was 'wrong' in its determination that a $0.009 access fee limitation was appropriate.

G. Commission Action to Cap Market Access Fees Would Raise Significant Anticompetitive Concerns under the Exchange Act

As discussed in detail in Section II.D. above, any attempt by the Commission to adopt limitations or restrictions on the market access fees that agency markets may charge for providing access to their order execution services would significantly impair their ability to receive compensation for their services, while artificially reducing the costs of doing business for dealer markets. Such action would give rise to significant anticompetitive concerns under the Exchange Act.

Section 23(a)(2) of the Exchange Act requires the Commission to consider the impact any rule or regulation would have on competition and prohibits the Commission from adopting any rule or regulation that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[60] Based on the Proposing Release, it does not appear that the Commission has made much of an attempt to perform the requisite undertaking. In the Proposing Release, the Commission provides several unsubstantiated assertions with respect to the impact of the proposed cap on market access fees on agency markets, but provides no evidence that it has undertaken any legitimate consideration of the competitive burden that the proposed cap actually would have on agency markets. The Commission simply states that "[t]he proposal may "adversely affect the limited number of ATSs that currently charge high access fees…[s]uch ATSs would likely be required to re-evaluate their business plans in light of the [proposal]" and "[h]igh volume ATSs, national securities exchanges, and Nasdaq would have to make minor to modest adjustments but would not, in the Commission's view, be significantly affected by the proposal."[61]

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[59] Id. at Section III.B.
[60] Section 23(a)(2) of the Exchange Act, 15 U.S.C. §78w(a)(2).
[61] Proposing Release at 133 (Section IV.F.).

H. If the Commission Determines to Adopt the Proposed Maximum Caps on Market Access Fees, It Should Make Certain Revisions to the Proposals to Eliminate Unnecessary Distinctions among Equally Valuable Trading Interest, Reduce Unnecessary Costs, and Limit Unintended Consequences

If the Commission determines to proceed with the adoption of a maximum cap on market access fees, however, Instinet Group strongly recommends that the Commission eliminate the requirement that broker-dealers must display attributed quotes to be eligible to charge a market access fee and limit any proposed cap to a single accumulated fee limitation, such as set forth in paragraph (b)(4) of proposed Rule 610. Without these revisions, the current proposal would create an unnecessary and ultimately meaningless distinction between otherwise equally valuable liquidity, raise the costs of market participants seeking anonymity for their orders, and its disparate treatment of ATSs, ECNs, and SROs would potentially result in competitive distortions and unintended consequences for these markets.

Currently, order-driven agency markets typically do not display attributed quotes. Rather, all orders displayed on these systems are anonymous. The reason is that as all orders are immediately accessible on one common limit order book, there is little value in disseminating the identity of the firm associated with the quotation. Under the proposal, however, quoting market centers whose users do not generally display their orders as attributable quotes, such as Archipelago Exchange, will be limited to charging $0.001 per share in total. In contrast, Nasdaq, which currently has a significant percentage of attributable quotes as a consequence of its historical role as an interdealer quotation system, effectively would be permitted to charge $0.002 per share in total since both Nasdaq and the member displaying an attributable quote could each charge $0.001 per share.

If the proposal is adopted in its current form, users of Archipelago Exchange likely would immediately see an increase in the use of attributed orders. While at first blush, this may seem to increase the amount of market information available, it will, in fact, have no impact and only increase the amount of data being disseminated. This is because Archipelago members that still prefer anonymity but still want to recoup the $0.001 charge (or at least a significant portion thereof) would simply display their orders through another broker. In effect, broker-dealers would be created simply to display attributed quotes on Archipelago to collect the $0.001 market access fee/rebate while still remaining anonymous by shielding their identity. Note that the cost of maintaining anonymity would rise as members seeking anonymity would incur greater clearing costs and would likely need to share their $0.001 market access fee/rebate with the attributed broker-dealer providing such anonymity.

Similarly, the only members of Nasdaq that can currently disseminate “attributed quotes” are market makers and ECNs. If the proposal were approved, however, Nasdaq would see an increase in the number of registered market makers and few, if any, market participants would use the anonymous SIZE feature in SuperMontage. Since there are few obligations associated with acting as a Nasdaq market maker, multiple order entry firms would register as market makers simply to capture the $0.001 market access fee associated with posting an attributable quote. As with

Archipelago, however, although more information will be disseminated, the value of that information would likely be very low since any market participant seeking anonymity could easily hide its identity through one of these new Nasdaq market makers. And, as with Archipelago, the cost of maintaining anonymity would rise.

At the same time, market makers already effectively have the ability to collect a market access fee through their participation in Nasdaq (or any other SRO marketplace) and their receipt of a liquidity rebate. Nothing other than the label of this arrangement is likely to change with the adoption of the proposed cap, as market makers are unlikely to incur the administrative burdens of directly collecting access fees, and would seek to have their SRO collect the fee on their behalf.

Therefore, as all broker-dealers would seek to retain what is effectively an access fee under the label of one, the attribution requirement is an unnecessary and ultimately meaningless distinction that will only raise costs for those non-market maker broker-dealers seeking to retain anonymity for their orders.

In addition, the current proposal creates significant potential for unintended consequences and introducing distortions in competition between and among ATSs, ECNs, and SRO markets. While ATSs and ECNs may charge $0.002 per share for displayed quotes accessed directly through their proprietary systems, SROs are limited to charging $0.001 per share in all situations. In the Supplemental Release, the Commission assumes that ATSs and ECNs effectively will be limited to charging $0.001 per share as they will be required to rebate $0.001 of the $0.002 to match the market access fee that a broker-dealer could charge by attributing an order through an SRO.[62] Whether or not this proves to be the result in practice is unknown. Would it have the further result of establishing a $0.001 floor for liquidity rebates? Is this a result the Commission desires to achieve? Moreover, if an ECN posts its quotes on a competing SRO that does not provide liquidity rebates, is it potentially disadvantaged vis-à-vis that SRO through the $0.001 cap on access fees the ECN can charge for a quotation accessed through an SRO? What other unintended consequences will arise out of the differing restrictions on ATSs, ECNs, and SRO markets? Restricting the market access fee cap to an accumulated fee limitation would reduce the unintended consequences while providing greater operational and pricing flexibility to these markets.

As for an appropriate amount for such an accumulated fee limitation, Instinet Group believes that there is no basis for adopting any limitation other than at the prevailing $0.003 per share level, which was arrived at through open competition among ATSs, ECNs, and SRO markets in the Nasdaq market.

[62] Supplemental Request for Comment at Section III.A.2.

III. Locked and Crossed Market Restrictions

Instinet Group does not believe that the public interest or Congress's goals for the NMS would be advanced through the adoption of Proposed Rule 610(c), which would require SROs to adopt rules requiring their members to avoid locking and crossing the displayed quotes of other markets. Indeed, we believe that enabling market participants to display quotations that lock or cross the market increases market transparency, efficiency, and encourages the display of limit orders by investors.

A. Why Locked and Crossed Markets Occur

Locked and crossed markets result from a variety of causes. First, locked markets are the natural result of competition among markets, and will exist even if efficient access exists between such markets, due to the microsecond updating of bids and offers in the competing markets participating in the NMS.

Second, locked and crossed markets occur because a market participant may make the determination that the quotation displayed by the locked or crossed market is not truly accessible, whether because of a lack of automation, lack of connectivity to that market, a low order fill rate, a high degree of slippage on that market, or because the cost of accessing that market is unacceptably high to the market participant.

Third, locked and crossed markets occur because of investors and broker-dealers' trading behavior. In this regard, even with the most efficient degree of access, a market participant will not always be successful in interacting with a particular quotation. The market participant may decide that the potential disadvantages of routing away outweigh the potential advantages. In this regard, it would lose its execution priority on the marketplace on which it is currently displaying its order. In addition, in considering the risk of the market price moving against it, the market participant may be willing to enter a locking order, but not to take the further step of executing against the locked order.

Moreover, a market participant may decide to exclusively use a particular market to run a trading strategy, even at the risk of missing some trading opportunities on away markets. Finally, a market participant may indeed decide to lock another market because of the availability of liquidity rebates.

B. Locked Markets Provide Valuable Benefits to the Market

Instinet Group believes that locked and crossed markets produce various benefits to investors and the markets. Locked and crossed markets provide valuable information as to the true level of trading interest on the market. Moreover, locked markets reduce the quoted spread, which should improve the execution prices investors receive from internalizing dealers, although in practice many dealers currently do not utilize locked market information in this fashion. In addition, locked markets provide important signals to market participants that the locked market may be inaccessible or its quote may be unreliable, providing incentives for such markets to improve their operations and informing their members of the existence of such problems, allowing them to take steps to influence the market to improve its operations or move their order flow to more responsive markets.

C. The Commission's Justifications for the Proposal Do Not Warrant the Adoption of the Proposed Restrictions on Locked and Crossed Markets

Instinet Group believes that the various justifications that the Commission has put forth in support of the proposal do not present a sufficient case to warrant adopting such a rule. First, the Commission states that locked and crossed markets "may raise concerns about the orderliness and efficiency of the markets" and the existence of locked markets "indicates that the bid or offer is not valid, that brokers are not diligently representing their clients, or that inefficiencies exist that deter trading with the quoting market."[63]

While locked and crossed markets at times do signal the existence of inefficiencies in the market, specifically market participants' concerns regarding the accessibility of a quote or inefficiencies in a manual market updating its quotation, Instinet Group believes that the answer is not to hide these inefficiencies from view by prohibiting their symptoms, i.e., locked and crossed markets, but by allowing these inefficiencies to be exposed and market forces to work to resolve them. Forcing market participants to not display quotations that would improve the current market price and shed light on the possible inefficiencies of the locked or crossed market compounds the problem of the inaccessible or inefficient market rather than resolving it.

Second, the Commission states that locked and crossed markets can cause confusion regarding the reliability of the displayed quote. We are unaware of any evidence that there is any significant degree of confusion on the part of investors when a locked or crossed market exists. Indeed, most investors, particularly retail investors, likely do not know what a locked or crossed market is.

Third, the Commission states that locked and crossed markets may create difficulties for market participants regarding the impact of a locked market on their best execution obligations to customers. Specifically, the Commission states that "some market centers' automatic execution systems may perceive the quotes to be stale or incorrect, and shut down."[64] In actuality, the automatic execution systems in question are those used by dealers to internalize customer orders. In the event of a locked market, the spread between the bid and offer price is zero, making it unprofitable for the dealer to trade against customer order flow. If legitimate concerns do exist as to the best execution obligations of a dealer to its customers during a locked market, the Commission or SROs could deal with the issue in a much less intrusive manner by providing market participants with interpretive guidance on this subject – the logical guidance being that customer orders are

[63] Proposing Release at 126 (Section IV.B.4.)
[64] Id at 109 (Section IV.A.2.).

entitled to the locked price. Prohibiting locked and crossed markets would simply guarantee a minimum spread for dealers, to the detriment of investors, particularly retail investors.

D. Any Locked and Crossed Market Restrictions Adopted Should Not Apply When an Exception to the Proposed Trade-Through Rule is in Effect

As explained earlier in Section I.I.5, Instinet Group does not believe that any locked and crossed market restriction should apply in instances where an exception to the proposed trade-through rule would be in effect, particularly the opt-out exception**.** The Commission recognizes that "for fully-electronic markets the ability to display a quote at a price is a prerequisite to trading at that price."[65] The utility of the opt-out exception would be seriously compromised, especially for electronic markets, if they could not display an opted-out order in their quotation at a price that would lock or cross another displayed quotation. Without being able to lock or cross the displayed market, opted-out orders would necessarily be undisplayed orders, depriving investors and the market of trading interest that would by definition improve the quoted market, as well as the opportunity to interact with such orders.

IV. Proposed Market Access Requirements for Quoting Market Centers and Quoting Market Participants

Proposed Rule 610(a) of Regulation NMS would prohibit order execution facilities operated by SROs ("quoting market centers") and market participants that display quotations in any SRO that does not provide an order execution facility ("quoting market participants") (e.g., NASD's Alternative Display Facility) from imposing unfairly discriminatory terms that would prevent or inhibit third parties from obtaining access to quotations or the execution of orders through a member or subscriber of the quoting market center or quoting market participant. Quoting market participants would also be required to make their quotations available for purposes of order execution to all quoting market centers and other quoting market participants on terms as favorable as provided to their most preferred customers.

Instinet Group believes that there is a strong public policy interest in ensuring that market participants have the ability to access, on reasonable and non-discriminatory terms, all publicly displayed trading interest in the NMS. As noted earlier, we believe that regulations requiring markets to be transparent and accessible constitute the fundamental "rules of the road" for the NMS that provide the greatest benefits for investors.

While we support the goals of the proposed market access requirements, we request that prior to taking further action on the proposal, the Commission provide further clarification as to the meaning and application of the "unfairly discriminatory" standard used in the proposal. The proposal appears to be a subjective, rather than an objective standard, which would not lend itself to readily determinable criteria that market participants could follow to ensure their compliance with

[65] Id at 128 (Section IV.B.4.).

the proposed requirements. In this regard, we note that the "unfairly discriminatory" standard differs from the standard used in the fair access requirement of Regulation ATS, which contains an objective component.[66]

We further believe that the Commission should clarify that the proposed market access requirement will not prevent quoting market centers, their members, and quoting market participants from continuing to provide volume pricing discounts and taking into account the varying costs of providing service to different categories of customers in establishing pricing for such customers.

V. Proposed Amendment to the Volume Threshold for the Application of the Fair Access Requirement of Regulation ATS

Instinet Group supports the Commission's proposal to revise the volume threshold for the application of the fair access requirement of Rule 301(b)(5) of Regulation ATS from twenty percent to five percent of the average daily trading volume of a security.[67]

Currently, the fair access requirement applies on a security-by-security basis to an ATS's trading in any security in which it accounts for twenty percent of the average daily trading volume in the security in any rolling four out of six calendar month period. The fair access requirement provides that ATSs that reach such volume thresholds in particular equity securities, must establish written access standards for its trading of such securities, and not unreasonably prohibit or limit any person in respect to access to services offered by such ATS by applying its access standards in an unfair or discriminatory manner.

In adopting the fair access requirement, the Commission stated that the twenty percent volume threshold was based on then-current market conditions. The Commission went on to state that:

> If there is a change in these market conditions, or if the Commission believes that alternative trading systems with less than twenty percent of the trading volume are engaging in inappropriate exclusionary practices or in anticompetitive conduct, the Commission may revisit these fair access thresholds. The Commission intends to monitor the impact and effect of these fair access rules, as well as the practices of alternative trading systems, and will consider changing these rules if necessary to prevent anticompetitive behavior and ensure that qualified investors have access to significant sources of liquidity in the securities market.[68]

We believe that the adoption of the Commission's proposed amendment to the fair access requirement volume threshold is an appropriate measure to ensure that market participants have a sufficient level of access to the services provided by ATSs that are significant market centers in the NMS.

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[66] Exchange Act Rule 301(b)(5), 17 CFR 240.301(b)(5).
[67] Exchange Act Rule 301(b)(5)(ii)(B), 17 CFR 240.301(b)(5)(ii)(B).
[68] Regulation ATS Adopting Release, supra note 14 at 63 FR 70873 n.245.

Further, we agree with the Commission that lowering the fair access volume threshold from 20% to 5% ADTV on a security-by-security basis is necessary to ensure equal regulation of, and a level competitive playing field among, ATSs (including ECNs) that are significant market centers in the NMS.

VI. Amendments to NMS Plan Market Data Revenue Allocation Formulas

A. Summary of Proposal

The Commission is proposing to amend the CQ, CTA, and Nasdaq – UTP Plans to replace the existing formulas governing the allocation of the net income generated by the Plans to their SRO participants, which amounted to a total of $386 million dollars in 2003.[69] The Commission's stated intent is to establish a more broad-based measure of an SRO's contribution to the data streams of the three Networks covered by these Plans (i.e., NYSE, Amex, and Nasdaq securities), than is provided by the existing allocation formulas, which are based on transaction reports in the case of the CQ and CTA Plans and the average of transaction reports and share volume in the case of the Nasdaq – UTP Plan.

The Commission believes that the existing formulas have caused a variety of economic and regulatory distortions. First, the existing formulas do not "reward those market centers that generate the highest quality quotes, i.e., those quotes that have the best prices and largest sizes."[70] Second, the existing formulas "create an incentive for SROs to operate 'print facilities' that report a large number of trades," which in the Commission's view allows "the purely economic consideration of maximizing market data revenues, rather than the quality of an SRO's regulatory expertise or trading services" to determine which SRO reports and regulates a trade.[71] Finally, the Commission believes exclusively trade-based formulas "create an incentive for fraudulent or distortive practices" by reporting a large number of very small trades, such as through illegal wash sales to generate market data revenues or "tape shredding" in which total trading volume is broken up into the smallest possible trade sizes to maximize the amount of revenues such data can generate.[72]

The Commission's proposed formula allocates each Network's total distributable net income among the securities included in a Network based on the square root of dollar volume of trading in each security to represent the importance of trading volume in each security. The net income for each security in a Network is then allocated through three measures: (1) the SRO's proportion of trading in that security ("Trading Share") (50%); (2) the SRO's proportion of quotes with prices that equal the NBBO ("Quoting Share") (35%); and (3) the SRO's proportion of quotes that improve the NBBO ("NBBO Improvement Share") (15%).

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[69] Proposing Release at 203 (Section VI.C.1.). The net income for Network A (NYSE-listed) was $162.1 million, Network B (Amex-listed) was $95.6 million, and Network C (Nasdaq-listed) was $128.2 million.
[70] Id.
[71] Id. at 204 (Section VI.C.1).
[72] Id.

B. The Commission Should Not Adopt the Proposed Formula as it Would Not Achieve Its Intended Goals, while Unnecessarily Creating Significant Market and Economic Distortions

Instinet Group believes that while in many respects the Commission's proposal is well-intentioned, it should not be adopted as it fails to provide any appreciable benefits for investors or advance Congress's goals for an NMS, raises significant potential risks for investor harm, and the distortions it seeks to address can be better dealt with through less intrusive means.

The fundamental problem with the Commission's proposed formula stems from the inherently low cost for market participants to generate quotation information and the consequent high potential for gaming behavior in any formula that attempts to reward such behavior. Recognizing this problem, the Commission's proposed formulas attempt to anticipate and prevent such behavior by micromanaging it away through arbitrary judgments as to value of certain market information, the consequence of which is to introduce even more distortive effects on market participants' behavior, create substantial potential for gaming behavior through their complexity, and reach arbitrary results.

For example, the Quoting Share measure seeks to reward quotes at the NBBO by providing SROs with credits for time and dollar size at the NBBO. Recognizing the potential for overcompensating the inaccessible or stale quotations from manual markets, the Quoting Share measure renders quotes from non-automated market centers left alone due to quote changes at other markets ineligible from earning further credits unless such entities resubmit their original quotations. One immediately recognizable distortive effect of this measure would be to incent manual marketplaces to change their quoting behavior for no purpose other than to maximize their Quoting Share credits.

Moreover, the NBBO Improvement Share is intended to reward market participants for submitting quotations that improve upon the then-existing NBBO by providing them with credits for (i) each five seconds of duration and the dollar size of their quotes that establish a new NBBO, with the intent of assuring credits are not earned for "ephemeral quotes," and (ii) trading activity related to the quote meeting certain requirements (reported while or within 5 seconds of the quote and at the same price). The measure also caps the overall credits associated with transactions in an attempt to maintain a reasonable relation between the quote and the credits that can be earned for it.
The assumptions inherent in attempting to identify the value of a particular quote are at best arbitrary. For instance, a quotation with a duration of less than five seconds is hardly "ephemeral" in today's marketplace – accessibility is the key attribute – and can provide significantly more value as to the direction of the market than one with a five second or more duration. In addition, limiting the value of a quotation to trading activity at a particular price is arbitrary as block trades rely on the NBBO as a reference price. Further, the trade reporting conditions are inconsistent with the current operation of the Nasdaq market, which gives market participants up to 90 seconds to submit trade reports.

The Trading Share measure also creates arbitrary results in an attempt to address issues with the existing formulas. This measure rewards SROs for their pro rata share of transaction reports in a security, but excludes from the calculation all transactions with a dollar volume below $5000. The Commission's stated purpose is to eliminate the "very small trades that often have the least price discovery value and reduce the potential for significant numbers of 'shredded trades.'"[73] However, the $5000 volume level floor produces arbitrary results in most cases. To take a reasonable example, the proposed $5000 share floor for eligible trades would exclude a 2000 share execution in a security trading at $2.49, while including a 200 share execution in a stock trading at $25.00. Under almost all possible permutations of relative trading volume, however, the execution in the stock trading at $2.49 would have greater relative informational value to the market.

Consequently, we believe the proposed allocation formula is an overly complex, arbitrary exercise that, if adopted, may well introduce many more economic and market distortions than it would resolve.

[73] Proposing Release at 209 (Section VI.C.2.b.i.).

C. Specific Response to Issues Raised in Supplemental Request for Comment

In the Supplemental Request for Comment, the Commission seeks comment on several potential modifications to the proposed market data revenue allocation formula. First, the Commission suggests that if floor-based exchanges such as the NYSE act on announced plans to implement automatic execution capabilities, displayed quotes would for NMS stocks may be "predominantly accessible through Auto-Ex Facilities" enabling the Commission to ignore quotes not accessible through auto-ex, eliminating the automatic cutoff applicable to manual quotes in the Quoting Share measure.[74] Second, the Commission requests comment on whether the NBBO Improvement Share measure should be eliminated if manual quotes were excluded from the Quoting Share measure, as the measure was intended to reward price leaders and offset the advantage manual quotations could have in calculating Quoting Share.

While the manual quote cutoff is one of the more egregious examples of the overly complex nature of the allocation formula, we believe that the proposal should be withdrawn rather than tweaked to account for potential market developments. With or without the implementation of auto-ex capabilities on listed markets, however, as the Nasdaq market is already predominantly accessible via auto-ex, we query why a cut-off for manual quotes even was proposed initially for Network C.

D. The Commission Should Instead Take Discrete, Less Intrusive Actions to Directly Address Certain Issues Relating to the Current Market Data Revenue Allocation System

Instinet Group believes that the Commission would best serve the interests of investors and the Congress's goals for the NMS by taking certain discrete, less intrusive measures to address directly the issues related to the current market data revenue allocation system. In this regard, the Commission should specifically prohibit the practice of tape shredding, continue to enforce existing prohibitions on wash sales under the Exchange Act,[75] and consider revising the CQ and CTA Plans to account for share volume as well as volume of transactions in allocating market data revenues generated by the sale of data from Networks A and B.

[74] Supplemental Request for Comment at IV.B.
[75] Section 9(a)(1) of the Exchange Act, 15 U.S.C. §78i(a)(1).

VII. Other Proposed Changes to Market Data-Related Regulations

A. Revisions to Existing Rules Regarding the Dissemination of Market Data

With certain limited exceptions, Instinet Group generally supports the adoption of the proposals to revise the existing rules governing the distribution and display of market data.

1. Revisions Relating to the Independent Dissemination of Trade Reports and Quotation Information

The Commission is proposing to revise Rule 11Aa3-1 (redesignated as Rule 601) to rescind the prohibition against the independent dissemination of trade reports by SROs and their members outside an NMS Plan. With respect to the independent distribution of quotation information, while current rules do not prohibit such distribution, the Commission is proposing to establish standards for the distribution of such information. Specifically, the Commission is proposing to require that any market participant that is the exclusive source of market information make such information available to securities information processors on terms that are fair and reasonable and to require any SRO, broker, or dealer that distributes market information to do so on terms that are not unreasonably discriminatory.

Instinet Group supports the rescission of the prohibition against the independent dissemination of trade reports by SROs and their members outside an NMS Plan. We do, however, have concerns with the Commission's establishment of standards over the independent distribution of trade reports and quotation data by SROs, brokers, and dealers. While the Commission takes pains to point out that it is establishing a lesser standard for "non-core" versus "core" data, the determination of what is "core" data is left to the Networks, albeit with the approval of an NMS Plan amendment accomplishing this by the Commission. This could lead to the result that Network participant markets could agree among themselves to offer a non-SRO's proprietary data for redistribution through the Network without any input from the affected non-SRO other than through the Commission's comment process for amendments to NMS Plans.

Moreover, we are concerned with the Commission's statement that its proposed standards "would prohibit, for example, a market center from distributing its data independently on a more timely basis than it makes available the 'core data' that is required to be disseminated through a Network processor." We request that the Commission clarify that this statement does not mean that a market center would have to artificially slow the independent delivery of its data to correlate with limitations imposed by a Network processor based on the processor's capacity or other limitations.

In addition, the Commission specifically requested comment on the issue of whether and on what terms Network processors should be required to disseminate non-core data on behalf of market centers, noting that the Nasdaq—UTP Plan Operating Committee has determined that the entity succeeding Nasdaq as processor should have the ability to disseminate depth of book information that a participant voluntarily provides, subject to the participant exclusively bearing the costs of such dissemination. We believe that at a minimum, if a Network processor provides any Network participant market with the ability to disseminate any type of non-core data through the Network, it must offer the same opportunity on the same terms to any other Network participant market.

In the particular case of Nasdaq, its historic role as Network C processor and the distribution of the Nasdaq Quotation Dissemination Service (Level II) quotes identifying Nasdaq market center participants through the shared Nasdaq market/Network processor infrastructure has conferred it a significant and ongoing competitive advantage over other market centers trading Nasdaq-listed stocks, which cannot disseminate attributed quotes through Network C. We believe that to redress the competitive imbalance, Nasdaq and any successor Network C processor must offer all participant markets the opportunity to disseminate attributed quotes through the Network.

2. Revisions Relating to the Consolidation of Trade Reports and Quotation Information

The Commission is proposing to revise substantially the consolidation requirements of Rule 11Ac1-2 (redesignated as Rule 603). First, the proposals would eliminate the requirement to provide a complete quote montage and limit the consolidated display to the prices, sizes, and market center identifications of the NBBO and last sale information. Second, the proposals would narrow the range of contexts triggering the requirement to those in which a trading or order routing decision could be implemented. Finally, the proposals would streamline the Rule's text to eliminate provisions tied to specific and generally outdated technologies.

Instinet Group believes that these proposals should be adopted as they would reduce some of the unnecessary regulatory burdens that the current Rule imposes on market participants. However, we do question whether a formal requirement to provide a consolidated display remains necessary in the context of today's information-rich markets and the proposed narrowing of the information required in a consolidated display, as broker-dealers and other market participants would appear to have sufficient incentives to provide a consolidated NBBO without a formal requirement to do so.

B. Creation of Market Data Advisory Committees

Instinet Group supports the adoption of the proposal that would require the NMS Plans to appoint advisory committees. We do not believe, however, that the appointment of such committees will have any real impact on the primary defects in the current NMS Plan arrangements, which stem from the conflicts of interest inherent in the continuing control of the exclusive processor function by the NYSE and Nasdaq, the competitive advantages such control has provided these entities, and the ability of Plan participants to block competitive initiatives of other participant markets.

In adopting the 1975 Amendments, Congress made absolutely clear that "provision must be made to insure that the [exclusive processor] is not under the control or domination of any particular market center"[76] and noted that "Sections 11A(b) and (c)(1) [of the Exchange Act] would grant the SEC broad powers over any exclusive processor and impose on that agency a responsibility to assure the processor's neutrality and the reasonableness of its charges in practice as well as in concept."[77] Therefore, we question why the Commission has enabled the NYSE to control the exclusive processor function for Network A securities through its 66.6% ownership of SIAC. SIAC's dual role as the *de facto* technology arm of the NYSE and exclusive processor raises serious conflict of interest and resource contention concerns.[78] We are unaware of the existence of any corporate governance or other safeguards at SIAC to prevent the NYSE's inappropriate use of its influence over SIAC to the detriment of other CQ and CTA Plan participants.

Consequently, we request that the Commission take action to meet its obligations under the Exchange Act and to address these concerns by adopting effective corporate governance safeguards for Network processors, require the NYSE to divest itself of its controlling interest in SIAC, or amend the CQ and CTA plans on its own initiative to appoint a new exclusive processor for Network A securities. Furthermore, we request that the Commission take the initiative to complete the process of replacing Nasdaq as exclusive processor for Network C securities, a process that has been underway for several years but still has not been completed.[79]

VIII. Proposed Restriction on Subpennies

[76] S.Rep, supra note 27, at 11.
[77] Id. at 12.
[78] Indeed, in noting that SIAC was to serve as the exclusive processor for transaction reports in exchange-listed securities, Congress stated:

> The Committee believes that if such a central facility is to be utilized the manner of its regulation cannot be overestimated. An exclusive processor of this sort will play a key role in determining how information about transactions in securities will reach the public. Its decisions as to who may report transactions through its facilities and in what manner will influence the extent and nature of competition among market facilities. And its decisions as to who may receive and disseminate the market information which it processes will structure the nature of the competition among vendors of market information.

Id. at 11.
[79] See Exchange Act Release No. 43863 (Jan. 19, 2001), 66 FR 8020 (Jan. 26, 2001) (File No. SR-NASD-99-53) (discussion of replacement of Nasdaq as exclusive processor).

Instinet Group recognizes the legitimate concerns some have raised with subpenny quoting and trading on a market-wide basis. However, we firmly believe that market forces, rather than government intervention, should determine the appropriate quotation increment for a security. Government intervention to fix the quotation increment will only cement the status quo and prevent marketplaces from making subsequent innovative changes to their quotation increments to respond to the needs of investors.

In this regard, market forces already have shown their responsiveness to the needs of investors. Currently, only one significant market center in the NMS permits quoting in subpennies for securities priced over $1.00. This market currently limits subpenny quoting to securities priced at $5.00 and below. Every other NMS market center that currently is eligible to quote in subpennies has, due to competitive forces, already adopted restrictions on or eliminated subpenny quoting.

At the same time, the market requires the flexibility to introduce subpenny quoting when it is appropriate. For example, since early March 2004, INET has limited quoting in every security it trades over $1.00 to penny increments, with the exception of the Nasdaq-100 Trust ("QQQ"). In INET's experience, QQQ has proven to be a true subpenny market where the usage of subpenny quotations generally is spread evenly across all price points. Consequently, subpenny usage is not simply grouped around $0.001 and $0.009, which would indicate that market participants may be engaging in 'subpenny jumping' (*i.e.*, using subpennies solely to gain priority over orders displayed at a penny increment). In fact, the average spread in QQQ on INET is under $0.003 (three tenths of a penny), well under the proposed penny increment. As a result, allowing subpenny quoting is saving investors money. We estimate that if all markets traded solely QQQ in subpennies, the savings would be approximately $150 million per year.

Another example indicating that subpenny trading may be warranted for a particular security priced over $1.00 is SIRIUS Satellite Radio ("SIRI"). Beginning in early March 2004, INET began quoting and trading SIRI in penny increments, rather than subpennies. Immediately, INET lost market share to Brut ECN, the only market then still trading SIRI in subpenny increments. Clearly, investors prefer to quote and trade SIRI in subpennies. INET has recently changed its quoting and trading in SIRI to subpennies. Other low-priced, widely-held companies such as Sun Microsystems Inc., Lucent Technologies Inc., and Nortel Networks Corporation are among the securities that may well be more efficiently quoted and traded in subpennies.

If the Commission adopts the proposed prohibition on subpenny quoting, however, market centers will lose the necessary flexibility to respond to the needs of investors and the marketplace. In the end, the real harm will come to investors, as spreads in certain securities will be fixed artificially at a level that is higher than necessary.

B. Insufficiency of Proposed Exemptive Relief

Proposed Rule 612(b) allows the Commission to exempt market participants from the application of the proposed prohibition. We believe, however, that the exemptive relief available in proposed Rule 612(b) is insufficient, as it would appear to be difficult to expect market centers to appeal successfully for relief when they are prohibited from demonstrating that a true subpenny market exists for a particular security.

C. Request for Specific Additional Exemption for QQQ and Other ETFs

If the Commission determines to proceed with the proposal, however, we request that the Commission provide a specific exception from the proposed rule for QQQ and other ETFs as the derivate nature of these particular securities enables investors to determine their true value at any point in time by calculating the aggregate price of the securities constituting a particular ETF, uniquely lending themselves to subpenny quoting and trading.

IX. Conclusion

Instinet Group again appreciates the opportunity to offer its comments on the Proposals. We look forward to the prospect of working together with the Commission in the process of modernizing the regulatory framework of the NMS to enable competition among markets and the application of technological advancements to benefit investors in accordance with Congress's goals for the NMS.

* * *

If you have any questions regarding our comments, please do not hesitate to contact me directly at 201.231.5501, or Jon Kroeper, FVP and Associate General Counsel, Instinet Group, LLC at 202.898.8438.

Sincerely yours,

Edward J. Nicoll

cc: The Honorable William J. Donaldson, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Raol C. Campos, Commissioner

Annette L. Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation

Giovanni Prezioso, General Counsel, Office of General Counsel

Attachments

Exhibit A

Table I-A
Comparison of Effective Spreads in S&P 500 Stocks (cents) *

Month	Nasdaq-Listed	NYSE-Listed
April 2003	1.15	2.12
May 2003	1.12	1.97
June 2003	1.23	2.03
July 2003	1.22	2.06
August 2003	1.19	1.92
September 2003	1.14	1.85
October 2003	1.20	1.84
November 2003	1.20	1.76
December 2003	1.21	1.72
January 2004	1.17	1.82
February 2004	2.73	1.92
March 2004	1.10	1.89
April 2004	1.09	1.85
Monthly Average	1.29	1.90

* Source: SEC Rule 11Ac1-5 data for covered marketable orders for months April 2003 – April 2004 (provided by Market Systems, Inc.; calculation of monthly average by Instinet Group).

Table I-B
Comparison of Execution Speed in S&P 500 Stocks (seconds)*

Month	Nasdaq-Listed	NYSE-Listed
April 2003	4.4	20.9
May 2003	5.0	21.2
June 2003	4.6	20.7
July 2003	4.8	20.4
August 2003	5.9	19.4
September 2003	6.3	19.9
October 2003	7.5	19.0
November 2003	6.7	18.4
December 2003	8.2	18.2
January 2004	5.1	18.5
February 2004	7.3	17.5
March 2004	7.3	16.4
April 2004	6.2	17.0
Monthly Average	6.1	19.0

Table I-C
Comparison of Execution Prices in S&P 500 Stocks (percentage)*

Month	**Nasdaq-Listed**			**NYSE-Listed**		
	At Quote	**Inside Quote**	**Outside Quote**	**At Quote**	**Inside Quote**	**Outside Quote**
Apr 2003	74.4	14.9	10.7	58.3	20.2	21.6
May 2003	76.2	13.9	9.8	60.3	19.5	20.2
June 2003	76.3	13.1	10.6	59.9	19.5	20.6
July 2003	76.5	13.5	9.9	61.2	18.5	20.3
Aug 2003	79.4	10.1	10.5	64.4	17.0	18.6
Sept 2003	80.0	10.5	9.5	62.7	18.0	19.3
Oct 2003	81.1	10.0	8.9	63.8	17.8	18.4
Nov 2003	82.2	8.9	8.8	65.2	17.1	17.7
Dec 2003	82.8	8.4	8.8	66.1	16.8	17.1
Jan 2004	83.3	8.5	8.2	63.7	18.2	18.0
Feb 2004	83.8	7.9	8.4	64.7	17.3	18.0
Mar 2004	85.6	6.0	8.4	64.7	17.1	18.2
Apr 2004	84.7	6.7	8.6	65.0	17.6	17.4
Monthly Average	80.5	10.2	9.3	63.1	18.0	18.9

* Source: SEC Rule 11Ac1-5 data for covered marketable orders for months April 2003 – April 2004 (provided by Market Systems, Inc.; calculation of monthly average by Instinet Group).

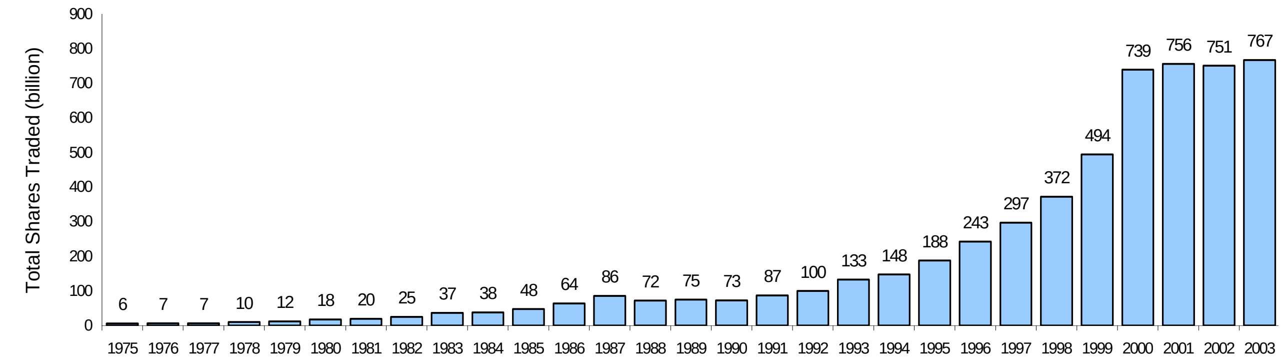
Table I-C
Comparison of Execution Prices in S&P 500 Stocks (percentage)*

Month	Nasdaq-Listed			NYSE-Listed		
	At Quote	**Inside Quote**	**Outside Quote**	**At Quote**	**Inside Quote**	**Outside Quote**
Apr 2003	74.4	14.9	10.7	58.3	20.2	21.6
May 2003	76.2	13.9	9.8	60.3	19.5	20.2
June 2003	76.3	13.1	10.6	59.9	19.5	20.6
July 2003	76.5	13.5	9.9	61.2	18.5	20.3
Aug 2003	79.4	10.1	10.5	64.4	17.0	18.6
Sept 2003	80.0	10.5	9.5	62.7	18.0	19.3
Oct 2003	81.1	10.0	8.9	63.8	17.8	18.4
Nov 2003	82.2	8.9	8.8	65.2	17.1	17.7
Dec 2003	82.8	8.4	8.8	66.1	16.8	17.1
Jan 2004	83.3	8.5	8.2	63.7	18.2	18.0
Feb 2004	83.8	7.9	8.4	64.7	17.3	18.0
Mar 2004	85.6	6.0	8.4	64.7	17.1	18.2
Apr 2004	84.7	6.7	8.6	65.0	17.6	17.4
Monthly Average	80.5	10.2	9.3	63.1	18.0	18.9

* Source: SEC Rule 11Ac1-5 data for covered marketable orders for months April 2003 – April 2004 (provided by Market Systems, Inc.; calculation of monthly average by Instinet Group).

Exhibit B

U.S. Historical Equity Growth*



Yr/Yr Growth (%)		15.8	2.3	38.3	18.5	52.8	9.1	26.5	50.7	1.9	26.1	33.6	33.0	(16.1)	4.6	(2.9)	18.5	15.3	33.7	10.7	27.5	28.9	22.4	25.1	33.0	49.4	2.3	(0.6)	2.0
5 Year CAGR (%)						24.3	22.8	28.1	30.3	26.5	21.7	26.8	28.1	13.9	14.5	8.7	6.1	3.1	13.2	14.5	20.9	22.9	24.4	22.7	27.3	31.4	25.5	20.4	15.6

*Reflects NYSE and Nasdaq volumes. Source: Meridian Securities