

Summary of Intended Testimony of Edward J. Nicoll, CEO, Instinet Group Incorporated, on Proposed Regulation NMS (File No. S7-10-04)

• **Introduction.**

- 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 technological advancements since the Commission's NMS regulations were first put into place in the 1970s.
- While we are still engaged in the process of evaluating the content of these interrelated proposals and fully understanding their various and potentially far reaching implications for investors and the U.S. equity markets, we are able to offer some of our preliminary views on these proposals to you today.

• **Trade-through Rule (Proposed Rule 611).**

- **Overall comment.** Instinet Group continues to believe strongly that the best and most appropriate solution to the issue of trade-through reform is the outright repeal of the ITS trade-through rule. By requiring market participants obligated to seek best execution for their customers and themselves to attempt to access markets other than those they would choose to access, the trade-through rule has inhibited competition among markets trading exchange-listed stocks, to the detriment of investors and the U.S. equity markets.
- As a result, Instinet Group has serious concerns about the potential negative consequences of imposing a trade-through rule in the Nasdaq market.
- However, if the Commission determines to proceed with the adoption of a trade-through rule for all NMS stocks, Instinet Group believes that it is absolutely critical that the Commission provide an effective opt out exception to the rule for sophisticated investors.

- **Rationale for the Opt Out Exception.** Instinet Group believes that an opt out exception is necessary because market participants believe that the so-called 'best price' or more accurately, the best advertised price, is not always an accessible price, and therefore may not be the true 'best price' for a stock at a given point in time. An effective opt out exception would provide investors and market participants with the ability to avoid interacting with a price they believe may not be there and instead to immediately execute their orders against what they believe is the best accessible price.
- An effective opt out exception will discipline order execution facilities to continue to provide ever more competitive, efficient, and accessible markets.
- Moreover, by providing a significant, ongoing incentive for all markets to display prices that are immediately accessible, an opt out exception would make a significant contribution to enhancing the integrity of the public quote.

- **Changes to the Proposal Necessary to Create an Effective Opt Out Exception.** The Commission should make the process of opting out an order as simple as possible for sophisticated investors to use and for their brokers to implement. The value of the opt out exemption is proportionate to its ease of use and implementation.
 - **Definition of Sophisticated Investor.** Instinet Group believes that for purposes of the opt out exception, a sophisticated investor should include any broker-dealer, institutional investor, or active trader.
 - **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).
 - **Allow Sophisticated Investors to Provide Broker-Dealers with Consent on a Global Basis.** To further streamline the process of effecting opt outs, 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.
 - **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.** This information is unlikely to be of value to most, if not all, sophisticated investors, who already have access to the information they need to assess the execution quality they receive. Providing them with the ability to decline the receipt of this information would reduce burdens on these investors and their broker-dealers.
- **The Commission Must Allow Opted Out Orders to be Displayed at Prices that Lock or Cross the Publicly Displayed Quotes of Other Markets.** The Commission recognizes 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.” Consequently, for any opt out 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 the ability to lock or cross displayed quotes would encourage the growth of hidden, non-transparent markets, and reduce order interaction among markets, as order execution facilities would only be able to utilize the exception by internalizing orders without displaying them to other market participants. By providing an opt out exception that allows order execution facilities to display opt out orders that lock or cross other markets, 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 and accessible to other market participants.

- **Automated Order Execution Facility Exception.** Instinet Group has serious questions regarding the appropriateness of the adoption of an automated order execution facility exception to the proposed trade through rule.
 - Instinet Group is concerned that in attempting to define what is an automated order execution facility the Commission effectively would be mandating market structure standards, which is inconsistent with the Commission's statutory role. Instinet Group also is concerned that any such definition would lead to a lowest common denominator solution, with little benefit and potential adverse consequences for market efficiency. In addition, Instinet Group is 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 automation of different market centers.
 - Instinet Group believes that the availability of an effective opt out exception for sophisticated investors would appropriately place the choice of which markets are immediately accessible in their hands, thereby obviating the need for the Commission to engage in the ultimately arbitrary exercise of attempting to do so by defining an automated order execution facility, or for that matter, adopting automated execution requirements discussed, but not proposed in the release.
- **Market Access Requirement (Proposed Rule 610(a)).**
 - Instinet Group believes that ensuring that market participants have the ability to access, either directly or indirectly, all publicly displayed trading interest in the NMS is a legitimate goal of Commission rulemaking.
 - Instinet Group requests that the Commission provide further clarification as to the meaning of the "unfairly discriminatory" standard used in the proposal, which differs from the "unreasonably discriminatory" standard used in the fair access requirement of Regulation ATS.
 - Instinet Group further believes that the Commission should clarify that the proposed market access requirement will not prevent quoting SRO 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 customers.
- **Access Fee Restrictions (Proposed Rule 610(b)).**
 - As the Commission has recognized on many past occasions, it does not possess the appropriate expertise to act as a ratemaking agency.
 - Instinet Group questions whether the Commission possesses the requisite statutory authority to impose the restrictions on fees that appear to be contemplated in the proposed rule.
 - Instinet Group does not believe that the Commission has provided an adequate basis to justify taking such an extreme step.

- Instinet Group believes that the proposed rule does not sufficiently identify what fees and other transaction charges would be impacted by the proposed rule.
 - Instinet Group believes it would be particularly inappropriate for the Commission to attempt to fix maximum access fees at levels substantially below those that are charged by most participants in a competitive marketplace.
 - Instinet Group believes that competition among market centers has been effective in reducing access fees in the past several years, and significant competitive pressure continues to be exerted on markets that charge access fees.
 - Instinet Group believes that if the Commission believes greater transparency is required to ensure quote comparability, a much less intrusive means of achieving it would be to require SROs and ATSS to publish their fee schedules.
 - Instinet Group believes that if broker-dealers other than ATSS should have the ability to charge access fees directly, then such broker-dealers also should be required to bear the obligations imposed on ATSS through Regulation ATS.
- **Locked and Crossed Market Restriction (Proposed Rule 610(c)).**
 - Instinet Group does not believe that the Commission should adopt a rule requiring SROs to adopt rules requiring their members to avoid locking and crossing the quotes of other market centers.
 - Instinet Group does not believe that the Commission has presented a sufficient case to warrant adopting such a rule.
 - Instinet Group believes that allowing locked markets is important as they provide valuable price information to the marketplace. Creating an artificially widened spread by imposing locked market restrictions would reduce market transparency and impede quote competition among market centers.
 - The Commission can more appropriately address quote integrity issues by incenting market centers to provide immediately accessible quotes, such as by adopting an opt out exception from the proposed trade through rule.
 - If the Commission is concerned about difficulties market participants may have regarding the impact of a locked market on their best execution obligations to customers, 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.
 - Instinet Group does not believe that any locked and crossed market restriction should apply in instances where the proposed trade through rule would not be in effect.
- **Change in Volume Threshold for the Application of the Regulation ATS Fair Access Requirement (Proposed Amendment to Rule 301(b)(5)).**
 - Instinet Group supports the proposal to revise the volume threshold for the application of the fair access requirement of Regulation ATS from twenty percent to five percent.

- Instinet Group agrees that changing the volume threshold is necessary to ensure equal regulation of, and a level competitive playing field among, ATSS that are significant market centers.
- **Restriction on Subpenny Trading (Proposed Rule 612).**
 - Instinet Group believes that market forces should be permitted to determine the appropriate trading increment for a security.
 - However, if the Commission determines to proceed with the proposal, Instinet Group requests that the Commission provide a specific exception from the proposed rule for ETFs.
- **Changes to NMS Plan Market Data Revenue Allocation Formulas.**
 - Given its admitted complexity, Instinet Group is still engaged in the process of analyzing and formulating a position with respect to the appropriateness of the terms of the proposed allocation formula.
 - Instinet Group requests that the Commission make publicly available any analyses it has performed or other data it has generated with respect to the proposed allocation formula to facilitate commenters' ability to provide meaningful comments on the formula.
- **Appointment of NMS Plan Advisory Committees.**
 - Instinet Group recommends the approval of the rule changes requiring the NMS Plans to appoint advisory committees. Instinet Group does not believe, however, that the appointment of such committees does anything to address the primary defects in NMS Plan governance, that is, the conflicts of interest inherent in having the exclusive processor function under the control of 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.