

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 52623 / October 18, 2005**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-12088**

**In the Matter of**

**Instinet, LLC and INET ATS,  
Inc.**

**Respondents.**

**ORDER INSTITUTING ADMINISTRATIVE  
AND CEASE-AND-DESIST PROCEEDINGS,  
MAKING FINDINGS, AND IMPOSING  
REMEDIAL SANCTIONS AND A  
CEASE-AND-DESIST ORDER PURSUANT  
TO SECTIONS 15(b) AND 21C OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**I.**

The Securities and Exchange Commission (“Commission” or “SEC”) deems it appropriate and in the public interest that administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”), against Instinet, LLC (“INCA”) and INET ATS, Inc. (“INET”), f/k/a the Island ECN, Inc. (“ISLD”).

**II.**

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlements (the “Offers”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or in which the Commission is a party, and without admitting or denying the findings contained herein, except as to the Commission’s jurisdiction over Respondents and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 (“Order”), as set forth below.

### III.

On the basis of this Order and Respondents' Offers, the Commission finds that:

#### Respondents

1. INET, a subsidiary of Instinet Group Incorporated (INGP), is a Jersey City, NJ-based registered broker-dealer that operates an alternative trading system pursuant to Regulation ATS. At the time of the conduct addressed in the order, INET was one of the largest venues of NASDAQ-listed equity trading, accounting for almost 25% of all NASDAQ trading volume. INET provided matching services for U.S. exchange-listed stocks and exchange-traded funds. INET is used by as many as 800 broker-dealers to fill both customer and proprietary orders. INET has been a member of NASD since December 24, 1987, and was known as the Island ECN, Inc. ("ISLD") until November 2003, when it changed its name to INET ATS, Inc.

2. INCA, a subsidiary of INGP, is a global electronic securities broker that provides its customers with electronic and sales trading execution services that enable buyers and sellers to trade securities directly and anonymously with one another or by executing trades in global securities markets. INCA's customers primarily consist of institutional investors, such as hedge funds, mutual funds, and pension funds. INCA, CRD No. 14408, then known as Instinet Corporation ("Old Instinet"), was a member of the NASD from December 1983 through July 2000. In July 2000, through a corporate reorganization, the assets and business of INCA were transferred to an affiliated broker-dealer entity, CRD No. 42886, which at that point changed its name to Instinet Corporation ("New Instinet"). Old Instinet had its name changed to Reuters C Corp., and subsequently withdrew its broker-dealer registration. In January 2004, New Instinet was merged up and into Instinet, LLC, a new entity created with the purpose of being the surviving broker-dealer entity from its merger with New Instinet. INCA, now known as Instinet, LLC still carries the same CRD No. 42886.

#### Summary

3. This matter concerns violations of Rule 11Ac1-5 of the Exchange Act<sup>1</sup> by INET and INCA. Rule 11Ac1-5 requires market centers to publish their order execution quality reports ("Execution Reports") for each calendar month to promote visibility and competition on the part of market centers and broker-dealers, placing particular emphasis on execution price and speed. See 17 C.F.R. 240.11Ac1-5. From June 2001 through May 2004, the Respondents repeatedly published monthly Execution Reports containing inaccurate order execution quality information. The effect of the erroneous reports varied. In some instances, the reporting errors resulted in execution quality statistics that made the Respondents' execution quality appear to be worse than was actually the case. In other instances, the reporting errors resulted in execution quality statistics being reported that made the Respondents' execution quality appear to be better than was actually the case.

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<sup>1</sup> Rule 11Ac1-5 was redesignated as Rule 605 under Regulation NMS. See Securities Exchange Act Release No. 51808 (July 10, 2004), 70 FR 37496.

## **Legal Discussion**

4. The Commission promulgated Rule 11Ac1-5 under Section 11A of the Exchange Act with the aim to improve public disclosure of the National Market System's order execution and routing practices in an effort to ensure that investors and broker-dealers responsible for obtaining best execution of their customer orders, receive the best execution for their orders. See Securities Exchange Act Release No. 43590 (December 1, 2000), 65 FR 75414. Rule 11Ac1-5 arose out of the Commission's extended inquiry into market fragmentation. Id. Specifically, Rule 11Ac1-5 provides investors with a means to evaluate the execution quality of trades executed by different trading centers through Execution Reports that can be reviewed by the public. The information contained in the reports is intended to provide "a starting point to promote visibility and competition on the part of market centers and broker-dealers, particularly on the factors of execution price and speed." Id.

5. In pertinent part, Rule 11Ac1-5 requires a "market center" that trades national market system securities to make available to the public monthly electronic reports that include uniform statistical measures of execution quality. In particular, subsection (b)(1) of Rule 11Ac1-5 requires every market center to "make available for each calendar month, in accordance with the procedures established pursuant to paragraph (b)(2) of this section, a report on the covered orders in national market system securities that it received for execution from any person." Subsection (b)(1) categorizes the reported data in such fields by security, order type, and order size; and includes additional information regarding order execution time, price improvement and shares executed inside and outside the quote. See 17 C.F.R. 240.11Ac1-5(b)(1). Subsection (b)(3) of Rule 11Ac1-5 requires a market center to "make available the report required by paragraph (b)(1) of this section within one month after the end of the month addressed in the report." See 17 C.F.R. 240.11Ac1-5(b)(3).

## **Findings**

6. INCA and ISLD published monthly Execution Reports beginning in June 2001. INET's first execution report was for the month of January 2004. Although INCA had completed its acquisition of ISLD in September 2002, they continued to operate as separate market centers and registered broker-dealers. Between December 2003 and February 2004, INCA and ISLD merged their trading platforms, forming INET as the single remaining ATS. The combined organization engaged in significant downsizing and restructuring of reporting lines across the company.

7. The Execution Reports published by INCA, ISLD and INET contained numerous errors from 2001 through 2004. All three entities relied heavily on automated systems to comply with the requirements of Rule 11Ac1-5. However, the Respondents did not adequately test the systems and, in circumstances in which errors were discovered, did not adequately respond to repeated findings of errors in the published Execution Reports. The resources allocated by the Respondents for compliance in this area were insufficient. As a result, NASD staff, SEC staff and third parties detected errors in the Execution Reports before the Respondents detected them. The

Execution Reports of INCA, ISLD, and INET were particularly important to all market participants due to the high percentage of Nasdaq volume executed by the Respondents.

### **INCA's Execution Reports**

8. From June 2001 through February 2004, when INCA ceased operating as an ATS, INCA's Execution Reports were faulty in several ways, including: misclassification of shares, miscounting of cancelled shares, improper exclusion of orders, double counting of shares, improper calculations based on erroneous times, improper categorizing of orders, and erroneous treatment of message data as covered orders.

9. The errors in INCA's reports stemmed from a variety of sources. In some instances INCA's programmers misinterpreted the rule. Systems errors also led to the improper handling of daylight savings time. A change in the vendor used by INCA to supply market data caused still further errors for a period of time.

10. INCA relied entirely on one technology employee to produce its Execution Reports until INCA ceased to operate as an ATS. The automated system in place for the preparation of execution reports from June 2001 through November 2003 caused every report to be flawed in at least one respect and some reports in more than three respects. Although there were numerous errors in the execution reports, when each error was discovered the Respondent corrected the programming to eliminate the error going forward, but did not review the whole system for accuracy. Furthermore, in only a few instances did INCA review and correct previously posted execution reports.

### **ISLD's Execution Reports**

11. Between August 2002 and January 2004, ISLD's Execution Reports contained significant errors, including misclassification of orders, inaccurate order execution information, incorrect calculation of spreads, and other calculation errors due to incomplete quote data.

12. Problems with ISLD's time records and quote data caused order and execution data to be misclassified in the August 2002 execution report. Although an ISLD employee determined that the execution report for August 2002 contained errors because it was based on incomplete quote data, no follow-up review was conducted to determine if the incomplete quote data had affected other reports. Additional problems with timely and complete quote data continued to affect ISLD's execution reports throughout 2003. ISLD's execution report for March 2003 was contaminated by inclusion of data from March 2002. Finally, ISLD failed to post the Execution Reports for October and November 2003 in a timely manner.

## INET's Execution Reports

13. INET began publishing Execution Reports in January 2004. However, INET's Execution Reports covering the months of February through July 2004 contained multiple errors due to programming issues, including incorrect calculations for effective and realized spreads, improper determinations regarding orders receiving price-improvement, improper determinations regarding whether trades were executed at-the-quote or outside-the-quote, misclassification of orders, failure to include all order execution information due to volume increases and incorrect trade execution information due to use of an incorrect price divisor.

14. NASD staff and numerous independent third parties identified errors and notified INET of the potential errors. INET ultimately reposted reports for February through May 2004, and in some instances, corrected and reposted multiple reports for the same month as new programming errors were identified. For example, INET's March 2004 Execution Report was reposted on five different occasions from June 2004 through November 2004 due to different errors. Between May and September 2004 INET received multiple notification of errors from Nasdaq staff, NASD staff, SEC staff and an independent third party vendor. In each case, INET's lone assigned technology employee researched each potential error. INET, however, failed to reassess its entire program for producing its Execution Reports in light of these repeated errors, and consequently continued to receive monthly notifications of additional errors, even in reports that had been already corrected and reposted.

15. As a result of the conduct described above, the Respondents willfully<sup>2</sup> violated Rule 11Ac1-5 and Section 11A of the Exchange Act, which requires market centers to make available to the public accurate, standardized, monthly reports of statistical information concerning their order executions.

## Undertakings

Respondents have undertaken to:

1. In 2006, Respondents shall retain a third party regulatory auditor ("Regulatory Auditor") not unacceptable to the Commission staff to conduct a comprehensive regulatory audit of Respondents' compliance program relating to Rule 11Ac1-5, which shall be concluded by the end of the calendar year 2006.

a. Respondents shall require the Regulatory Auditor to assess (i) whether Respondents' policies and procedures are reasonably designed and effective to detect and deter violations of Rule 11Ac1-5, and (ii) whether Respondents are in substantial compliance with those policies and procedures.

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<sup>2</sup> "Willfully" as used in this Order means intentionally committing the act which constitutes the violation, see *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). There is no requirement that the actor also be aware that he is violating one of the Rules or Acts.

b. Respondents shall require the Regulatory Auditor to develop a written regulatory audit plan of sufficient scope and detail to achieve the regulatory audit objectives. In performing the regulatory audit, the Regulatory Auditor and other qualified persons hired by the Regulatory Auditor (“qualified persons”) shall have or acquire within a reasonable period of time adequate knowledge and understanding of Respondents’ policies and procedures. The Regulatory Auditor and the qualified persons shall exercise due professional care and independence in performing the regulatory audit. The Regulatory Auditor shall formulate conclusions concerning its assessment, as described in Paragraph 1.a. above, based on sufficient evidence that is obtained through, among other things, (i) inspection of documents, including written procedures, rules, and staff files, and (ii) interviews of appropriate personnel of Respondents. Respondents shall cooperate fully with the Regulatory Auditor and qualified persons and provide the Regulatory Auditor and qualified persons with access to their files, books, records (excluding any privileged documents), and staff as reasonably requested for the regulatory audit.

c. No later than 45 days after the regulatory audit is concluded, Respondents shall require the Regulatory Auditor to submit to Respondents’ Boards of Directors and to the Director of the Office of Compliance Inspections and Examinations, the Director of Market Regulation (the “Commission Officials”) and to NASD, the Regulatory Auditor’s conclusions concerning its assessment as to (i) whether each Respondent’s policies and procedures are reasonably designed and effective to detect and deter violations of Rule 11Ac1-5, and (ii) whether each Respondent is in substantial compliance with the above-referenced policies and procedures.

d. No later than 45 days after the regulatory audit is concluded, Respondents shall require that the Regulatory Auditor submit a regulatory audit report to Respondents’ Boards of Directors, to the Commission Officials and NASD (i) describing the purpose, scope and nature of the regulatory audit, and (ii) identifying any significant deficiencies or weaknesses in Respondents’ policies and procedures with respect to Rule 11Ac1-5 or any failure to comply with those policies and procedures.

e. Respondents shall bear the full expense of the regulatory audits.

f. Respondents shall require the Regulatory Auditor to agree not to withhold from the Commission or the Commission’s staff and NASD or NASD’s staff any documents or information on the basis of any privilege or work product claims that the Regulatory Auditor may have in response to any of the Commission staff’s or NASD’s staff requests.

g. Respondents shall require the Regulatory Auditor to enter into an agreement that provides that for the period of engagement and for a period of two years after completion of the engagement, the Regulatory Auditor shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Respondents, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Regulatory Auditor

will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Regulatory Auditor in performance of his/her duties under this Order shall not, without prior written consent of the Board of Directors, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Respondents, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

2. Respondents shall retain an independent third party, not unacceptable to the Commission staff, to confirm the accuracy of the Respondents' monthly Rule 11Ac1-5 Reports for a period of five years, provided however, that Respondents shall not be required to continue monthly audits if, after conducting the comprehensive regulatory audit in 2006, the Regulatory Auditor concludes, pursuant to paragraph 1.c. above, that Respondents (i) have policies and procedures with respect to Rule 11Ac1-5 reasonably designed and effective to detect and deter violations of Rule 11Ac1-5, and (ii) are in substantial compliance with such policies and procedures.

3. Notwithstanding the above, in the event that either or both Respondents shall cease being subject to the requirements of Rule 11Ac1-5 at any time during the period of 2006, such Respondent or Respondents shall not be required to retain or continue to engage a regulatory auditor or third party auditor pursuant to paragraphs 1 and 2 of these Undertakings.

#### IV.

In determining to accept the Offers, the Commission considered remedial acts promptly undertaken by the Respondents after they were contacted by Commission staff, the cooperation afforded the Commission staff and these Undertakings.

#### V.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offers.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondents cease and desist from committing or causing any violations and any future violations of Section 11A of the Exchange Act and Rule 11Ac1-5 thereunder;

B. It is further ORDERED that Respondents shall, within 30 days of the entry of this Order, pay a civil penalty of \$700,000 (\$350,000 to be paid by each Respondent) to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, Stop 0-3, VA

22312; and (D) submitted under cover letter that identifies Instinet, LLC and INET ATS, Inc. as Respondents in these proceedings, the file number of these proceedings. A copy of the cover letter and money order or check shall be sent to Peter H. Bresnan, Division of Enforcement, Securities and Exchange Commission, 100 F Street NE, Stop 0911, Washington, DC 20549; and

C. Respondents shall comply with the undertakings enumerated in Section III. above.

By the Commission.

Jonathan G. Katz  
Secretary