

INSTINET GROUP

January 26, 2005

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

Re: Reproposal of Regulation NMS, Securities Exchange Act Release No. 50870 (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 (“SEC” or “Commission”) with its comments on the recently repropoed Regulation NMS (“Reproposal”).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-five years. We operate our two main businesses through Instinet, LLC,² and Inet ATS, Inc. (“INET”).³

On June 30, 2004, Instinet Group submitted a comment letter setting forth its views on the initial Regulation NMS proposal and the issues raised in the Supplemental Request for Comment.⁴ Where applicable, this letter incorporates by reference the views contained in our Initial Comment Letter.

¹ Exchange Act Rel. No. 50870 (Dec. 16, 2004), 69 FR 77424 (Dec. 27, 2004) (“Reproposing Release”). The SEC originally proposed Regulation NMS in Exchange Act Rel. No. 49325 (Feb. 26, 2004), 69 FR 11126 (Mar. 9, 2004) (“Proposing Release”) and subsequently requested further comment on certain aspects of the proposal in Exchange Act Rel. No. 49749 (May 21, 2004), 69 FR 30141 (May 26, 2004) (“Supplemental Request for Comment”).

² Instinet, the Unconflicted 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, provides its U.S. broker-dealer customers one of the most robust liquidity pools in Nasdaq equities, substantial liquidity in U.S. exchange-listed securities, and routing access to other major U.S. trading venues. Additional information regarding INET can be found at <http://www.inetats.com>.

⁴ See Letter from Edward J. Nicoll, CEO, Instinet Group, to Jonathan G. Katz, Secretary, SEC, dated June 30, 2004 (“Initial Comment Letter”).

Executive Summary

Reproposed Trade-Through Rule

- Instinet Group does not believe that a strict trade-through rule such as that proposed by the Commission is in the best interests of investors or the markets.
- We believe our position is strongly supported by the most relevant data on trade-throughs provided by the Commission's Office of Economic Analysis, which show that trade-throughs only account for 2.5% of trades and 1.9% of volume in Nasdaq stocks, where no trade-through rule is currently in place, and 2.5% of trades and 1.2% of volume in NYSE stocks, where the much-criticized ITS trade-through rule prevails.
- The Commission has not only failed to demonstrate that there is any paucity of limit orders in the U.S. equities markets (its original justification for a trade-through rule), but its very own data makes clear that investors are not withholding limit orders from the market because they may be traded through.
- If the Commission nonetheless determines to adopt its reproposed trade-through rule, however, we believe that the Commission should limit the scope of the rule to the trading of NYSE-listed stocks. Given the existing high degree of market quality, robust competition and innovation, and low incidence of actual trade-throughs exhibited on the Nasdaq market in the absence of a trade-through rule, we can discern no legitimate justification for extending the rule to the trading of Nasdaq-listed stocks.
- We see no legitimate policy or practical justification for limiting the scope of protected quotes under the reproposed rule by adopting the Market BBO Alternative instead of the Voluntary Depth Alternative. Once the policy determination is made that limit orders should be protected by force of rule, the only logically consistent course of action is to protect as many limit orders as possible. We anticipate little difference in the costs to market participants and the damage to intermarket competition associated with a trade-through rule limited to top of book as compared to one that extends to depth of book. These costs and burdens overwhelmingly come from the imposition of a trade-through itself, not the scope of the rule.

Reproposed Maximum Cap on Market Access Fees

- Instinet Group reiterates its strongly held belief that the Commission should not adopt any 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.
- If the Commission determines to proceed with the adoption of a maximum cap on market access fees, however, Instinet Group believes that 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, as provided for in the Reproposal. In addition, Instinet Group believes that the Reproposal does improve upon the original proposal by addressing its unnecessary discrimination against market participants entering unattributed orders, reducing the potential for unintended consequences, and simplifying the administration of any final rule.

Reproposed Restrictions on Locked and Crossed Markets

- Instinet Group strongly opposes the adoption of the repropoled 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. We believe that enabling market participants to lock or cross manual quotations will do little to mitigate the negative impact the repropoled restrictions will have on market efficiency and transparency.

Reproposed 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 any action on the Reproposal, however, Instinet reiterates its request that the Commission should clarify the meaning and proposed application of its “unfairly discriminatory” standard.

Reproposed Revision to Volume Threshold for the Application of the Regulation ATS Fair Access Requirement

- Instinet Group supports the adoption of the repropoled 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.

Reproposed Restriction 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 shown their responsiveness, largely limit subpenny quoting to securities priced under \$1.00, with the exception of a small number of high volume securities with active subpenny markets.

- 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 (“QQQQ”) and certain other securities with demonstrated active subpenny markets. The Commission also should further facilitate the process of obtaining exemptive relief from the prohibition.

Reproposed Revisions to NMS Plan Market Data Revenue Allocation Formulas

- Instinet Group opposes the adoption of the reproposed 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 reproposed 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.
- Instinet Group continues to believe that 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.

Reproposed Revisions to Market Data Dissemination Requirements

- Instinet Group generally favors the adoption of the various reproposed revisions to the Commission’s rules relating to the independent dissemination of market data by SROs and their members outside an NMS Plan. Even with the clarifications provided in the Reproposing Release, Instinet Group continues to have specific concerns regarding the content of the proposed standards for such dissemination, the distinction between “core” and “non-core” data, and their implications.
- Instinet Group favors the adoption of the reproposed revisions to the consolidation requirements of redesignated Rule 603, but still questions the continued necessity of a formal consolidated display requirement in light of the ubiquity of market data in today’s markets.
- Instinet Group continues to support the creation of market data advisory subcommittees to the NMS Plans, but believes that such entities are in no way a substitute for direct and immediate Commission action to address the serious and ongoing conflicts of interest and competitive concerns inherent in the NYSE and Nasdaq’s control of the Network processors.

I. Reproposed Trade-Through Rule

A. The Commission Should Not Adopt the Reproposed Trade-Through Rule

Instinet Group continues to believe that a strict trade-through rule such as that proposed by the Commission is not in the best interests of investors or the markets. Our Initial Comment Letter laid out the case for our position in detail. We still believe our position is correct and, in fact, is strengthened by the most relevant data on trade-throughs provided by the Commission in its Reproposing Release.

We note, however, that we were willing to support the initial proposed trade-through rule, but this support was premised on the availability of an effective opt-out exception, which we believe would have mitigated many of the negative aspects inherent in a mandatory market interaction rule such as the proposed trade-through rule. Specifically, an opt-out exception would have preserved a continuing incentive for competition among markets, thereby allowing the demonstrated innovation and efficiencies such competition provides to continue in the Nasdaq market and to be brought to the market for NYSE-listed stocks, which has been insulated from competition by the ITS trade-through rule.

However, the Commission's reproposed trade-through rule does not include an opt-out exception or any other mechanism to counterbalance the rule's anticompetitive effects, inevitable unintended consequences, or costs. Consequently, we cannot support the adoption of the reproposed trade-through rule, even with the revisions made in the Reproposal. In this regard, we do not believe that the exclusion of manual quotations from the definition of "protected quotations" and the new so-called "tailored exceptions" to the reproposed rule are adequate substitutes for an effective opt-out exception.

B. The Commission's Own Economic Analysis Does Not Provide Support for the Adoption of any Trade-Through Rule

In the Proposing Release and Supplemental Request for Comment, the Commission's primary justification for the adoption of a strict trade-through rule for Nasdaq and NYSE stocks was to encourage the submission of limit orders by investors. The Commission, however, failed to provide any empirical evidence that the equities markets were suffering from a paucity of limit orders, that the ability of market participants to trade through displayed quotes was the culprit, or that the adoption of a strict trade-through rule would be the cure. In other words, there was no evidence of a widespread market failure that would necessitate a major regulatory response like the proposed trade-through rule.

In response to commenters, the Commission's Office of Economic Analysis ("OEA") undertook an analysis to attempt to determine the true extent of trade-throughs

on the markets for Nasdaq- and NYSE-listed stocks.⁵ While issues could be raised regarding the scope of the analysis (four trading days in 2003) and its methodology, we will accept for purposes of argument what OEA described as “more conservative” estimates of the rates of trade-throughs in Nasdaq- and NYSE-listed stocks (*i.e.*, using a three second quote window, with trade-through volume identified as total displayed depth).⁶ OEA found that the level of trade-throughs are extremely low in both Nasdaq- and NYSE-listed stocks, accounting for 2.5% of trades and 1.9% of volume in Nasdaq-listed stocks and 2.5% of trades and 1.2% of volume in NYSE stocks.⁷

These numbers alone should have given the Commission cause to step back and reconsider whether to proceed with its proposed rule, as its major justification for the proposal – that trade-throughs are deterring investors from placing limit orders, the fundamental building blocks of the market – is not substantiated. It is untenable to assert that investors are withholding limit orders from the market because they may be traded through 2.5% of the time, or put another way, because they will not be traded through only 97.5% of the time.

But instead, confronted with having a solution in hand without a real problem to solve, the Commission has attempted to find other purposes for the trade-through rule. In the Reproposing Release, the Commission cites the following as “weaknesses” in the Nasdaq and NYSE markets that are best addressed by the adoption of its repropounded trade-through rule, namely: a high degree of “slippage” on the NYSE market, and low fill rates for large orders and an excess of “transitory volatility” on the Nasdaq market.⁸

In this regard, while we ourselves made a point of a high level of slippage as being an issue in the NYSE market, we believe the more appropriate and less intrusive solution is to open up the NYSE market to competition by rescinding the ITS trade-through rule, rather than to dictate a specific solution by only granting trade-through protection to automated quotes, as the Commission seeks to accomplish.⁹ In addition, we believe that the Commission is misplaced in its contention that low fill rates in Nasdaq stocks is a weakness of that market. Low fill rates are a phenomenon intrinsic to

⁵ SEC, OEA, Analysis of Trade-throughs in Nasdaq and NYSE Issues (Dec. 15, 2004) at 2.

⁶ We find no justification for the use of any number other than total displayed depth to analyze the volume of trade-throughs. The proposed trade-through rule itself defines a trade-through by reference to an execution at a price inferior to a “protected quote,” which is limited to publicly displayed trading interest. Further, the Commission provides no basis for its assumption that latent (*i.e.*, undisplayed) interest at the price of displayed depth would be displayed and thus protected under its new trade-through regime. To the contrary, our experience has been that market participants’ primary motivation for not displaying their limit orders to the market is because the market impact that results from disclosing their trading intentions publicly increases their trading costs, not because they are concerned with having their orders traded through.

⁷ *Id.*

⁸ Proposing Release at 34-36.

⁹ *Id.* at 35

electronic markets in which market participants are free to cancel and replace orders. By permitting market participants to immediately enter and cancel limit orders, market participants are more willing to provide liquidity to the market at more aggressive prices, knowing that they can cancel such orders on demand, which provides a net benefit to investors. To the extent that this explains low fill rates on marketable limit orders, we believe this is a strength rather than a weakness of the Nasdaq market. A further explanation for low fill rates on large marketable limit orders is that the Nasdaq market has a significant number of low-priced stocks. Due to the lack of publicly displayed sub-penny prices in these stocks, many market participants are forced to lock markets in large size (though relatively low dollar amounts), giving the appearance of an unfilled marketable limit order which, in fact, is really an order of a user that intentionally locked the quote of another market. In addition, many of the market centers in the Nasdaq market have significant reserve orders behind their displayed quotations. It is commonplace for market participants to route oversized marketable limit orders to attempt to interact with the reserve size behind a displayed quotation. This also could explain the lower fill rates. There is no reason to believe that the imposition of a trade-through rule on the Nasdaq market will have any real effect on fill rates in Nasdaq stocks. Finally, we would contest the basis for the insinuation by OEA that because it found the level of transitory volatility on the Nasdaq market to be higher than the NYSE market, this is somehow indicative of a shortage of liquidity on the Nasdaq market.

Moreover, the Commission provides absolutely no evidence, empirical or otherwise, that would suggest that a trade-through rule actually would address any of these purported “weaknesses” or, even assuming *arguendo* that it would, that it is the most effective or least disruptive and costly means of doing so. In the case of low fill rates and transitory volatility on the Nasdaq market, the Commission merely makes the conclusory statements that the rule is “designed to enhance depth and liquidity and thereby improve the execution quality of large orders in Nasdaq stocks” and “by promoting greater depth and liquidity help reduce excessive transitory volatility in Nasdaq stocks.”¹⁰ Such statements surely cannot substantiate the adoption of a rule that will impose substantial costs and have unknowable consequences for markets, market participants, and investors alike.

Finally, the Commission attempts to make the case for adopting a trade-through rule by stating that competitive forces are insufficient to strengthen intermarket price protection and improve the quality of trading in Nasdaq- and NYSE-listed stocks because of principal/agent conflicts of interest and market participants’ free riding on displayed prices. Essentially, the Commission is making an argument that these are market failures that a trade-through rule is necessary to address. But again, the Commission’s argument is undercut by its own analysis showing very low levels of trade-throughs on the Nasdaq and NYSE markets.

¹⁰ Id. at 35 and 36.

In conclusion, the familiar dictum “first, do no harm” applies with equal weight to regulators as well as physicians. Absent compelling evidence of market failure, the responsible and prudent course of action to avoid harming the nation’s equity markets is for the Commission to refrain from adopting regulations with significant costs and unknown consequences. In this instance, we believe that the Commission’s own analysis demonstrates that the level of trade-throughs in the Nasdaq and NYSE markets do not provide evidence of a market failure, and therefore the Commission lacks a sufficient basis for the imposition of a trade-through rule. We further believe there is no basis for the Commission’s assertion that the repropose trade-through rule would increase fill rates or reduce transitory volatility on the Nasdaq market (or, for that matter, whether these are in fact “weaknesses” that need to be addressed), and that the appropriate cure for excessive slippage on the NYSE market is to open that market up to competition by repealing the ITS trade-through rule, not by adopting a strict trade-through rule. Consequently, we strongly urge the Commission to refrain from adopting its repropose trade-through rule.

C. The Commission Should Not Extend Any Final Trade-Through Rule to the Trading of Nasdaq-Listed Stocks

If the Commission determines to proceed with the adoption of the repropose trade-through rule, however, we continue to believe that the Commission should limit the scope of the rule to the trading of NYSE-listed stocks. Given the existing high degree of market quality, robust competition and innovation, and low incidence of actual trade-throughs exhibited on the Nasdaq market, we can discern no legitimate justification for extending the rule to the trading of Nasdaq-listed stocks.

The Nasdaq market has arrived at its current high state of performance through the unleashing of competition in that market by the Commission in the aftermath of the Nasdaq market maker collusion scandal in the early 1990s. In that instance, a clear market failure was found, and the Commission appropriately acted through the adoption of the Order Handling Rules. The result has been the emergence of a high-quality, competitive and innovative market with an extremely low level of trade-throughs *in the absence of a trade-through rule*.

In the present case, no evidence of market failure exists to justify the imposition of a trade-through rule on the Nasdaq market, which would impose real costs and undercut the competition among markets that has driven the Nasdaq market to its current impressive level of performance and made this market the primary source of innovations in the U.S. securities markets over the past decade. Moreover, no evidence exists that the repropose trade-through rule actually would reduce the level of trade-throughs on the Nasdaq market from where they are today, given that the Reproposal provides for a number of exceptions from the rule. Should the Commission therefore impose the costs of a trade-through rule on the Nasdaq market and put at risk the competition, efficiency,

and innovation that exists today in an attempt to reduce trade-throughs on that market from their already low levels? The only responsible answer is no.

In contrast, a legitimate case can be made for regulatory intervention in the NYSE market. The Commission's analysis has found that the level of trade throughs in the NYSE market, where the ITS trade-through rule currently applies, is comparable to that of the Nasdaq market. In our opinion, the low level of trade-throughs in the NYSE market is due to the historical centralization of order flow on the NYSE market, which the ITS trade-through rule has played a key role in preserving at the cost of blunting competition that would have spurred the NYSE's modernization into a truly automated market.

In this regard, the NYSE's total market capitalization is approximately four times greater than Nasdaq's and 93 of the 100 stocks in the S&P 100 are NYSE-listed stocks.¹¹ Yet, on a share basis, Nasdaq generally trades significantly more shares on a daily basis, while on a dollar volume basis, trading on the NYSE was only about 35% larger than Nasdaq in 2003.¹² The conclusion we draw from these numbers is that NYSE trading volume is artificially low and that trading costs are unnecessarily high. Further, as we noted earlier, every major innovation in the U.S. equity markets over the past 10 years has come from the Nasdaq market. Thus, in contrast to the Nasdaq market, a strong case can be made that regulatory intervention is legitimate to address the market failure in the NYSE market created by the ITS trade-through rule.

D. No Legitimate Justification Exists to Limit the Scope of Any Final Trade-Through Rule to the Market BBO Alternative or to Add a Block Trade Exception

While Instinet Group does not endorse the adoption of the repropose trade-through rule, we see no legitimate policy or practical justification for limiting the scope of protected quotes under the rule by adopting the Market BBO Alternative instead of the Voluntary Depth Alternative. Once the policy determination is made that limit orders should be protected by force of rule, the only logically consistent course of action is to protect as many limit orders as possible. We anticipate little difference between the expected costs and damage to intermarket competition associated with a trade-through rule limited to top of book versus one that extends to depth of book. These costs and burdens overwhelmingly come from the imposition of a trade-through itself, not the scope of the rule. Consequently, we see no logical consistency in the positions taken by certain market participants who strenuously argued for the originally proposed trade-through rule as necessary to protect the sanctity of limit orders, yet now oppose the

¹¹ Reproposing Release at 149 (SEC data derived from annual reports of the NYSE and Nasdaq and statistics compiled by the World Federation of Exchanges); SEC, Division of Market Regulation, Comparative Analysis of Rule 11Ac1-5 Statistics by S&P Index, (Dec. 15, 2004) at 1.

¹² Reproposing Release at 149 (SEC data derived from annual reports of the NYSE and Nasdaq and statistics compiled by the World Federation of Exchanges).

Voluntary Depth Alternative. Their opposition exposes their positions on the original proposal as arrived at simply to advance their own commercial interests, not the interest of protecting limit orders, or for that matter, investors.

Finally, we see no legitimate or practical justification for the Commission to add any type of block exception to any final trade-through rule. Again, if the Commission has made the policy determination to protect limit orders by force of rule, the only logically consistent course of action is to apply such a rule to orders of all sizes. Market participants advocating a block exception under a trade-through regime are simply doing so to advance their own commercial interests.

II. Reproposed Restrictions on Market Access Fees

We continue to oppose the reproposed restrictions on market access fees for all the same reasons cited in our Initial Comment Letter. Specifically, 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. Moreover, Instinet Group questions whether the Commission actually possesses the requisite statutory authority to impose the proposed cap. Further, 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 the cap.

That being said, however, if the Commission determines to adopt the reproposed restrictions on market access fees, we do believe that the Reproposal is an improvement on the initial proposal in several ways. First, by eliminating the attribution requirement, the Reproposal avoids creating a meaningless distinction between equally valuable trading interest that would only have served to raise the costs of market participants seeking anonymity for their orders and treated otherwise similarly situated ECNs, ATSS, and SRO trading centers in a disparate manner. Second, by limiting the proposed cap to a single accumulated fee limitation, the Reproposal reduces the potential for unintended consequences, and simplifies the ongoing administration of the cap.

Third, as for an appropriate amount for such an accumulated fee limitation, the Reproposal at least sets the cap at the prevailing \$0.003 per share level for stocks priced above \$1.00, which was arrived at through open competition among marketplaces. However, we believe that the Commission should reconsider the .3% of stock price cap for securities priced under \$1.00 or impose similar price-based caps on NSCC and other clearing charges to prevent these costs from becoming disproportionately burdensome for market participants, particularly agency markets, who trade such stocks.¹³

Additionally, we note that the Reproposal would allow market makers and other non-ATS broker-dealers to charge an access fee to market participants that execute against their protected quotations. We believe that the promotion of full access to protected quotations and the equal regulation of trading centers requires the Commission to subject these market participants to the equivalent of the fair access requirement of Regulation ATS if these entities make the trading interest reflected in their protected quotations accessible by means other than through an SRO's trading facility.

III. Reproposed Restrictions on Locked and Crossed Markets

Instinet Group continues to believe that neither the public interest nor Congress's goals for the NMS would be advanced through the adoption of reproposed Rule 610(d), which would require SROs to adopt rules requiring their members to avoid locking and crossing the displayed quotes of other markets. For the reasons set forth in our Initial Comment Letter, 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.

The Reproposal's minor concession of enabling market participants to lock or cross manual quotations will do little to mitigate the negative consequences to market efficiency and transparency that will result from the imposition of the restrictions. Consequently, we would request that the Commission refrain from adopting the restrictions on locked and crossed markets contained in reproposed Rule 610(d).

IV. Reproposed Market Access Requirements for SRO Trading Facilities and Trading Centers

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 in our Initial Comment Letter, we believe that regulations requiring markets to be transparent and

¹³ See, DTCC, User's Guide to the NSCC Fee Schedule (Jan. 5, 2005 version), available at <http://www.nscf.com/legal/nscfFeeGuide.com>.

accessible constitute the fundamental “rules of the road” for the NMS that provide the greatest benefits for all investors.

While we continue to support the goals of the repropoed market access requirements, we reiterate our request that prior to taking final action on the Reproposal, 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 the proposed requirements.¹⁴

Separately, we appreciate the Commission’s clarification in the Reproposing Release that the repropoed market access requirement will not prevent SRO trading facilities, their members, and trading centers displaying quotes through SRO display-only facilities from continuing to provide volume pricing discounts and reasonably taking into account the varying costs of providing service to different categories of customers in establishing pricing for such customers.

V. Reproposed Amendment to the Volume Threshold for the Application of the Fair Access Requirements of Regulation ATS

Instinet Group continues to support the adoption of the repropoed 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. We believe that reducing the volume threshold for the application of the fair access requirement would help to ensure equal regulation of, and a level competitive playing field among, all ATSs that are significant market centers in the NMS.

VI. Amendments to NMS Plan Market Data Revenue Allocation Formulas

A. Summary of Reproposed Allocation Formula

In the Reproposal, the Commission has made significant changes to its proposal formula 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 2003.¹⁵ 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 than is provided by the existing allocation formulas, which are based on transaction reports in

¹⁴ 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. See Exchange Act Rule 301(b)(5), 17 CFR 240.301(b)(5).

¹⁵ 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.

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’s repropose formula continues to allocate 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 (“Security Income Allocation”) with the stated intent of redressing what it viewed as a disproportional allocation of revenues to a relatively small number of stocks with high trading volume to the detriment of the remainder of stocks with lower trading volume under the existing formulas. However, conceding that the initially proposed formula “was very complex and may have been difficult to implement effectively,”¹⁶ the repropose formula reworks the mechanism by which the net income for each security in a Network is then allocated to the individual SROs. In the initial proposal, the SIA for each security in a Network was allocated to each SRO 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%). The Reproposal eliminates the NBBO Improvement Share measure and allots its share of the SIA to Quoting Share. Thus, under the Reproposal, the SIA for each security in a Network is allocated to each SRO in an amount generally equal to 50% of the SRO’s Trading Share in the security and 50% of the SRO’s Quoting Share in the security. The Reproposal also eliminates the ability of manual quotes to earn an allocation under the Quoting Share measure.

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.

With respect to the SIA, we believe that the use of a square root of dollar volume function to determine the SIA for each Network security is hardly a “marginal” reallocation of Network revenues between the most actively traded stocks and less actively-traded stocks. If the Commission nevertheless decides to adopt an SIA that reallocates income among Network securities, Instinet Group recommends that the Commission select a function that produces a more modest reallocation of revenues from actively-traded to less actively-traded securities.

¹⁶ Reproposing Release at 156 (Section V.A.3.a.).

As we stated in our initial comment letter, the fundamental problem with the Commission's proposed Quoting Share 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 formula attempts 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.

In this regard, the Quoting Share measure seeks to reward quotes at the NBBO by providing SROs with credits for time and dollar size at the NBBO. While the Reproposal eliminates one easily identifiable aspect of potential gaming behavior by eliminating credits for manual quotations, significant potential for gaming behavior exists. For example, market participants can gain quote credits simply by posting and canceling quotes in illiquid stocks. While the Commission appears to put its faith in order-routing technologies to impose market discipline on such behavior by reducing the potential for low-cost quotations at the NBBO to gain quote credits,¹⁷ we are not as sanguine that this will in fact be the result.

The reproposed 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 only includes transactions with a dollar volume below \$5000 on a proportional basis (e.g., a \$2500 trade would constitute ½ of a qualified trade report). The Commission states its belief that its revised approach would reduce allocations for "shredded trades" while still recognizing the price discovery value of small trades.¹⁸ The \$5000 threshold for full credit as a qualified trade report still produces arbitrary results in most cases (although somewhat less so than did the initially proposed threshold).¹⁹ Further, as the Division of Market Regulation reportedly has requested each SRO to address the practice of trade shredding by modifying their rules, adopting any threshold for qualified trades would seem to be particularly unwarranted.²⁰

As a result, we believe the reproposed allocation formula, while less complex than the initially proposed formula, remains an arbitrary exercise that, if adopted, may well introduce many more economic and market distortions than it would resolve.

¹⁷ Reproposing Release at 159 (Section V.A.3.b.)

¹⁸ Proposing Release at 209 (Section VI.C.2.b.i.).

¹⁹ For example, the proposed \$5000 share floor for eligible trades would only provide ½ credit to a 2000 share execution in a security trading at \$2.49, while providing full credit to 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 informational value to the market.

²⁰ Deborah Solomon, SEC Urges U.S. Stock Markets to Help Stop Splitting of Trades, WALL ST. J., Jan. 25, 2005, at C3.

C. 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 continues to believe 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, we reiterate our previous suggestions that the Commission should specifically prohibit the practice of tape shredding, continue to enforce existing prohibitions on wash sales under the Exchange Act,²¹ 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.

VII. Other Reproposed Changes to Market Data-Related Regulations

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

Instinet Group continues to generally support the adoption of the revisions to the existing rules governing the distribution and display of market data, with certain limited exceptions.

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

The Commission is reproposing its revision of 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 Reproposal would 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 reproposed rescission of the prohibition against the independent dissemination of trade reports by SROs and their members outside an NMS Plan. We do, however, have continuing concerns with the Commission's establishment of standards over the independent distribution of trade reports and quotation data by SROs, brokers, and dealers.

²¹ Section 9(a)(1) of the Exchange Act, 15 U.S.C. §78i(a)(1).

While the Commission again took pains in the Reproposing Release to point out that it is establishing a lesser standard for “non-core” versus “core” data (“not unreasonably discriminatory” versus “fair and reasonable”) the Commission provides very little in the way of guidance as to (1) what data is “core” data and “non-core” data; and (2) what is the practical difference between the “not unreasonably discriminatory” and “fair and reasonable” standards. In addition, it appears that 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.

We do, however, appreciate the Commission’s response to our request for clarification to its statement in the Proposing Release 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.” In the Reproposing Release, the Commission made clear that this statement does not mean that a market center would have to artificially slow the independent delivery of its data to correlate with restrictions imposed by a Network processor based on the processor’s capacity or other limitations.

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

The Commission is reproposing the adoption of substantial revisions to 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 reiterates its belief 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 continue to 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 repropoed amendment to the NMS Plans that would require the Plans to appoint advisory committees. We have little hope, 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.

Consequently, we reiterate our request that the Commission take action to meet its obligations under the Exchange Act and to address our previously stated 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.²²

VIII. Reproposed Restrictions on Subpenny Quotations

A. The Commission Should Not Adopt the Proposed Restrictions on Subpenny Quotations

While recognizing that there may be some legitimate concerns with subpenny quoting and trading on a market-wide basis, we firmly believe that market forces, rather than government intervention, should determine the appropriate quotation increment for a particular 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.

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, which will unnecessarily increase investors' transaction costs.

We believe that INET's recent experience in allowing a limited number of securities to be quoted in subpenny increments demonstrates that there are securities other than ETFs for which subpenny quoting is appropriate. INET is providing the

²² 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).

Commission under separate cover an analysis of its experience with subpenny increments in these securities that we believe will provide ample evidence in support of our position.

B. Insufficiency of Reproposed Exemptive Relief

Reproposed Rule 612(c) allows the Commission to exempt market participants from the application of the repropose prohibition. We believe, however, that the exemptive relief available in repropose Rule 612(c) remains 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. In this regard, we would recommend that the Commission adopt explicit criteria for exemptive relief in a particular security, such as regular quoting at the minimum increment with significant size at the bid and offer.

C. Request for Specific Exemption for QQQQ and Other NMS Stocks

If the Commission determines to proceed with the proposal, however, we request that the Commission provide a specific exemption from the proposed rule for QQQQ and certain other NMS Stocks. In the case of QQQQ and other ETFs, we are encouraged by the Commission's statement in the Reproposing Release that "[a]t this time, the Commission believes that a basis likely may exist to grant an exemption from the sub-penny quoting prohibition for QQQQ and perhaps other actively-traded ETFs." We believe that INET's analysis will demonstrate that there are a number of other actively traded securities that the Commission should exempt from the application of any prohibition it may ultimately adopt.

D. Acceptance of Sub-Penny Quotations

Reproposed Rule 612(a) continues to prohibit market centers and broker-dealers from displaying, ranking, or even accepting quotations in NMS Stocks that are priced in subpennies. One commenter argued that a market participant should be allowed to accept sub-penny quotations if it consistently re-prices such quotations to acceptable increment and does not give the sub-penny quotations any special priority for ranking or execution purposes. The Commission disagreed with the commenter citing that it believed there was little purpose for allowing market participants to accept such quotations and the rounding of such quotations could cause confusion among investors. We did not ourselves comment on this issue in our initial comment letter as we believed that the term "accept" would not preclude a market center from repricing an order to the appropriate increment upon receipt of the order, but prior to placement in its matching system. We respectfully disagree with the Commission that there is any real potential for confusion among investors that would merit market participants making the changes to their systems to comply with this aspect of the prohibition.

Jonathan G. Katz
U.S. Securities and Exchange Commission
January 26, 2005
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IX. Conclusion

Instinet Group again appreciates the opportunity to offer its comments on re-proposed Regulation NMS. We look forward to the prospect of working together with the Commission in modernizing the regulatory framework of the NMS, based on sound empirical data, 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
Chief Executive Officer

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 Roel C. Campos, Commissioner

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

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