

INSTINET GROUP

March 8, 2005

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

Re: Exchange Act Release No. 50699 (File No. S7-39-04)

Dear Mr. Katz,

Introduction

Instinet Group Incorporated (Instinet Group) welcomes the opportunity to comment on the U.S. Securities and Exchange Commission's (SEC or Commission) proposed rulemaking regarding the administration and governance of self-regulatory organizations (SROs) that are national securities exchanges or national securities associations (Proposal).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

Instinet Group commends the Commission for its efforts to enhance governance and transparency requirements applicable to SROs. Well-publicized corporate governance and accounting scandals have harmed investor confidence in the markets and resulted in far-reaching changes to the corporate governance and transparency requirements applicable to listed companies. The Proposal would apply many of the same requirements to SROs, which appear warranted by the recent governance and self-regulatory failings that are alleged to have occurred at a number of SROs. In addition, the Proposal provides a much-needed roadmap to the governance and transparency

¹ Exchange Act Rel. No. 50699 (Nov. 18, 2004), 69 FR 71126 (Dec. 8, 2004) (Proposing Release). The Commission subsequently extended the comment period on the Proposal in Exchange Act Rel. No. 51019 (Jan. 11, 2005), 70 FR 2829 (Jan. 18, 2005).

² Instinet, LLC, branded as 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>.

requirements expected of entities seeking to register as national securities exchanges or associations.⁴

While Instinet Group generally supports the adoption of the Proposal, we would respectfully request that the Commission revise certain aspects of the Proposal, as discussed below, prior to taking any final action. We believe that these revisions would allow the Commission to fully achieve its intended policy goals through this rulemaking while lessening the possibility of any unnecessary adverse impact on the self-regulatory programs and business activities of SROs and SRO trading facilities.

I. Proposed Rule 6a-5

Instinet Group supports the adoption of Rule 6a-5 as proposed, with the exception of the ownership and voting restrictions of Rule 6a-5(o). We believe that Rule 6a-5 is an important advancement in the governance requirements applicable to SROs. Rule 6a-5 will raise these standards up to those required of listed companies, which is warranted not only as a matter of equity and general good governance practices, but also by the quasi-governmental powers vested in and exercised by SROs.

We do, however, question the necessity of the SRO ownership and voting interest restrictions that Rule 6a-5(o) would impose on members of the SRO and their related persons. While we recognize the Commission's interest in ensuring against the potential risk that a member could use its controlling interest in its regulator to influence the regulatory process to its benefit, we question the continued need for such restrictions generally given the controls that the Proposal would impose at the SRO level, including a majority independent board with Standing Committees composed solely of independent directors; a functional separation of the business and self-regulatory operations of SROs, including the appointment of a Chief Regulatory Officer who reports to a fully independent regulatory committee which sets the self-regulatory budget; and much expanded financial and programmatic transparency into the self-regulatory process itself.

Nevertheless, if the Commission determines to proceed with the adoption of proposed Rule 6a-5(o), Instinet Group recommends that the Commission revise the Proposal to provide an explicit generic exemption from this provision for an affiliated member broker-dealer of the SRO whose activities are limited to: (1) providing SRO members with the ability to route orders to external destinations; and (2) sponsoring order entry and execution access to the SRO's trading facilities. We believe that such an exemption is warranted for several reasons.

First, an SRO-affiliated broker whose business is limited to external routing and sponsored access does not present the same concerns as would an affiliated member

⁴ As the Commission is aware, our subsidiary Inet Stock Exchange, LLC submitted a draft application for registration as a national securities exchange with the SEC staff in May 2004 and continues to work with the staff towards the filing of a formal application for exchange registration.

broker-dealer that trades for its own account and/or carries customer accounts. The serious violations of the federal securities laws and SRO rules that would appear to be able to generate the potential conflicts of interest cited by the Commission in proposing the member ownership and voting interest restrictions are those that arise out of proprietary trading and/or the carrying of customer accounts – insider trading, trading ahead of customer orders, market manipulation, to name a few – not the activities of brokers limited to routing and sponsoring access on an agency basis.

Second, as the Commission has previously determined, an SRO-affiliated member broker that performs external routing (and under certain circumstances one that sponsors access) will be regulated as a facility of the SRO.⁵ Consequently, if the Commission is satisfied that the other elements of the Proposal will provide an adequate framework to manage the conflicts of interest between the business and self-regulatory functions of an SRO, then they should be adequate with respect to any facility of the SRO.

Third, the granting of an exemption for an affiliated routing and sponsored access broker furthers the intermarket market access paradigm that the Commission seeks to establish through the adoption of Rule 610 of proposed Regulation NMS, which is premised upon market participants obtaining access to markets operated by SROs through broker-dealer members of SROs, rather than through bilateral or multilateral access agreements among SROs.⁶

Finally, two SROs currently have non-exclusive external routing and/or sponsored access arrangements in place with affiliated brokers.⁷ These arrangements provide real and potential operational efficiencies to the SROs and their users. Moreover, we are not aware of any particular regulatory concerns caused by these arrangements, nor has the Commission brought any to our attention in proposing Rule 6a-5(o) without an explicit exemption for such affiliated brokers.

⁵ See Exchange Act Rel. No. 44983 (Oct. 25, 2001), 66 FR 55225 (Nov. 1, 2001) (File No. SR-PCX-00-25). Wave Securities, LLC (Wave) is a broker-dealer, wholly-owned subsidiary of Archipelago Holdings, affiliate and ETP Holder of Archipelago Exchange (ArcaEx) that provides non-exclusive external routing from and sponsored access to ArcaEx. In approving ArcaEx to operate as a facility of the Pacific Exchange (PCX), the SEC found that the external routing function of Wave was a facility of PCX. *Id.* at 55233-34. The SEC further found that while Wave should not necessarily be viewed as a facility of PCX with respect to its sponsored access function, that analysis would change if Wave became the “sole or predominant source of sponsored access to PCX.” *Id.* at 55234-35. See also Exchange Act Rel. No. 50311 (Sept. 3, 2004), 69 FR 54818 (Sept. 10, 2004). Brut ECN, LLC (Brut) is a broker-dealer and wholly-owned subsidiary of The NASDAQ Stock Market, Inc (NASDAQ). The SEC stated that Brut is a facility of NASDAQ as defined in Section 3(a)(2) of the Act as it is the property of NASDAQ used for the purpose of effecting or reporting securities transactions. Brut currently provides external routing to its subscribers and under NASDAQ’s proposed rules for the operation of Brut as a facility of NASDAQ, Brut will offer external routing to NASD members who have executed a system subscriber agreement. Exchange Act Rel. No. 51078 (Jan. 25, 2005), 70 FR (Jan. 31, 2005) (File No. SR-NASD-2004-173).

⁶ Exchange Act Rel. No. 50870 (Dec. 16, 2004), 69 FR 77424 (Dec. 27, 2004) (File No. S7-10-04) (Proposed Rule 610 of Regulation NMS).

⁷ Specifically, the ArcaEx/Wave and NASDAQ/Brut relationships described in n.5, *supra*.

If the Commission nonetheless believes that the concerns animating the adoption of the ownership and voting restrictions of proposed Rule 6a-5(o) continue to exist in the case of an affiliated broker whose activities are limited to providing external routing and sponsored access, we believe that any such concerns can be addressed through the adoption of one or more specific conditions to the granting of such exemptions. In this regard, the Commission could require that any such affiliated broker also become a member of another SRO, and pursuant to Rule 17d-1 under the Securities Exchange Act of 1934 (“Act”) designate another SRO with responsibility for examining the broker for compliance with financial responsibility rules, eliminating any potential for conflicts of interest and adequate regulatory oversight with respect to such rules.⁸ The Commission could further require the SRO to enter into a plan with another SRO pursuant to Rule 17d-2 under the Act with respect to other aspects of its regulatory responsibilities for the affiliated broker.⁹

In the alternative to such arrangements, or with respect to those aspects of the regulation of an affiliated broker that are not allocated to another SRO, the Commission could impose regular reporting obligations on the SRO regarding its oversight of the affiliated broker as part of proposed Rule 17a-26 (or otherwise) and require the SRO to conduct an annual independent third party audit of such oversight.

II. Proposed Rule 17a-26

The Commission is proposing to adopt new Rule 17a-26 under the Act to establish a system of quarterly and annual reporting by SROs with respect to key aspects of their regulatory programs. While we believe that it is appropriate for the Commission to require SROs to prepare and submit such reports, we request that the Commission, prior to adopting any final rule, confirm that the scope of the information sought in the proposed reports matches its actual oversight needs, in light of the not insignificant burdens that its collection, preparation, and submission may impose on SROs’ regulatory programs.

There is one proposed element of the annual report, however, that we believe should be broadened in its application if ultimately adopted. Proposed Rule 17a-26(a)(2) would require each SRO that owns, operates, or sponsors an electronic SRO trading facility to file with the Commission an audit report of an independent third party that assesses whether the operations of the facility comply with the rules governing the facility. The Commission’s stated rationale for the proposed audit requirement is to “determine whether the systems aspects of electronic SRO trading facilities align with the rules that govern such facilities.”¹⁰ We see no reason why this requirement should not be extended to manual or hybrid SRO trading facilities as the same, or an arguably greater,

⁸ Exchange Act Rule 17d-1, 17 CFR 240.17d-1.

⁹ Exchange Act Rule 17d-2, 17 CFR 240.17d-2.

¹⁰ Proposal at 69 FR 71177.

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potential for lack of alignment between actual practice and rules exists for these types of trading facilities. As a result, we believe the Commission should revise the language of proposed Rule 17a-26(a)(2) to require annual independent third party audit reports of all types of SRO trading facilities.

III. Revisions to Form 1

The Commission is revising the Form 1 application for registration as a national securities exchange, particularly in light of the enhanced requirements applicable to SROs as a result of proposed Rules 6a-5 and 17a-26.

As a general observation, we believe that certain of the required exhibits to the proposed Form 1 are not particularly well-suited to new applicants for exchange registration, as they presume that the entity currently is engaged in operations as an exchange, which is not the case for new applicants.¹¹ In adopting a revised Form 1, we request that the Commission should consider whether it should provide any additional guidance for new applicants in completing various exhibits to the application or explicitly indicate whether particular aspects of the application do not pertain to new applicants.

IV. Conclusion

Instinet Group again appreciates the opportunity to offer its comments on the Proposal. 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

¹¹ See, e.g., Exhibit H (Items 4 and 5); Exhibit I (request for applicant's audited financial statements; Items 4 and 5); Exhibit S and Exhibit T.

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