March 14, 2003

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File No. SR-NASD-2003-09

Dear Mr. Katz:

Instinet Corporation ("Instinet") [1] appreciates the opportunity to share with the Securities and Exchange Commission (the "Commission") its comments on the proposal submitted by the NASD, on an immediately effective basis, to establish a permanent fee schedule for the Alternative Display Facility ("ADF").[2]

Instinet strongly supports the NASD's Proposal as a balanced approach that, consistent with Section 15A(b)(5) of the Securities Exchange Act of 1934 ("Act"),[3] equitably allocates ADF fees among all potential types of ADF market participants – market makers, ECNs, and order entry firms alike. Instinet also believes that the adoption of the Proposal is critical to ensuring that the NASD continues to meet both its statutory obligations under the Act to provide its members trading off-exchange with quotation display and trade reporting facilities and the condition imposed in the Commission's order approving the Nasdaq Stock Market, Inc.'s ("Nasdaq") SuperMontage system that the NASD provide its members with a quotation display and trade reporting alternative to their participation in SuperMontage. Accordingly, Instinet believes that the Proposal also is consistent with Section 15A(b)(6) of the Act,[4] which, among other things, requires NASD rules to remove impediments to and perfect the mechanism of a free and open market and a national market system.

[1] Instinet is a registered broker headquartered in New York City. Together with its affiliates, Instinet currently trades in forty global markets and is a member of twenty exchanges around the world. Instinet is a pure agency broker, serving its global client base by consistently reducing transaction costs, and thereby increasing investment performance for investors and their proxies. More information about Instinet and its activities is available on Instinet's web site at *www.instinet.com*.

[2] Securities Exchange Act Release No. 47331 (February 10, 2003), 68 FR 7635, (February 14, 2003) (File No. SR-NASD-2003-09) (the "ADF Fee Proposal" or "Proposal").

[3] 15 U.S.C. 78o-3(b)(5).

[4] 15 U.S.C. 78o-3(b)(6).

However, Instinet is quite concerned about the misimpressions that could arise in the minds of the Commission, its staff, and other market participants from some of the statements and assertions made in Nasdaq's comment letter on the Proposal.[5] Consequently, Instinet believes it is necessary to respond in detail to a number of Nasdaq's statements and assertions.

To begin, the Nasdaq Letter states that the ADF is a "creature of regulatory fiat rather than a competitive response to a marketplace need…" This is a curious statement for Nasdaq to make, given its own origins and continuation as a creature of regulatory fiat. Nasdaq was created in 1971 to fulfill the NASD's statutory obligation to provide an electronic quotation display mechanism for the over-the-counter market.[6] As an entity still under the control of the NASD, and along with the ADF available for NASD members to meet their quotation display, trade reporting, and other obligations under the Act and NASD rules, Nasdaq continues to be a creature of regulatory fiat. This statement is all the more curious given that the ADF was created to ensure that NASD members had a competitive over-the-counter alternative to Nasdaq's proprietary facilities. Without the ADF, Nasdaq would currently enjoy a regulatory monopoly in the trading of Nasdaq-quoted securities in the over-the-counter market.

The Nasdaq Letter then states that "the creation and propagation of a government-mandated marketplace into a crowded field of competing markets raises the concern that the government-mandated market [i.e., the ADF] will be able to exploit its unique position as the chosen market and crowd out the other competitors…." As Nasdaq should well know, the NASD has carefully delimited the functions to be performed by the ADF in Nasdaq-quoted securities to quotation display and trade reporting services so as to not operate a full-fledged marketplace offering those services (order routing and order matching services) that would put it into direct competition with NASD members.[7] The NASD thereby specifically avoids the distortive effects on competition that have resulted from Nasdaq's own entry into open competition with NASD members with its SuperSOES and SuperMontage order matching services.

It is Nasdaq that sought to "exploit its unique position as the chosen market and crowd out other competitors" with SuperSOES and SuperMontage. In this regard, the quotes and orders Nasdaq market participants submit to Nasdaq to meet their quotation display obligations under Commission and NASD regulations are used by Nasdaq to fuel the SuperSOES and SuperMontage order matching services that compete with those same NASD members. Moreover, Nasdaq continues to "exploit its unique position as the chosen market" over its exchange competitors as full-fledged marketplaces in the trading of Nasdaq-quoted securities by virtue of its continuing association with the NASD, which

[5] Letter from Edward S. Knight, E.V.P. and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, Commission, dated February 25, 2003 ("Nasdaq Letter").
[6] 15 U.S.C. 78o-3(b)(11).
[7] See, e.g., Securities Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49822 (July 31, 2002) (File No. SR-NASD-2002-97) at 49843 n.9.

enables Nasdaq to uniquely offer a decentralized market structure (i.e., no intramarket priority rules apply across Nasdaq market participants' trading activity). As a result, Nasdaq's exchange competitors are severely restricted in their ability to attract quotes and orders from multiple NASD members that traditionally used Nasdaq quotation and trade reporting facilities while conducting their order matching activities in Nasdaq-quoted securities, since unlike Nasdaq rules, exchange rules would require them to subject each potential match to being broken up by pre-existing trading interest of other exchange members.

The Nasdaq Letter's further assertion that "it could be argued that [the] ADF's participation in the marketplace is now an anachronism that currently serves no public purpose and only creates harmful distortions in the operation of the market" has little to recommend it both in the context of the historical rationale for the creation of Nasdaq itself and the Act's explicit interest in continued competition between exchanges and the over-the-counter market. In adopting Section 11A of the Act in 1975, Congress found that it was in the public interest to "assure fair competition … between exchange markets and markets other than exchange markets."[8] Consistent with this objective, the rules adopted by the Commission to facilitate the establishment of a national market system have required the NASD to provide for the collection and dissemination of quotations and transactions by NASD members trading Nasdaq-quoted securities in the over-the-counter market.[9]

As a result, without the availability of the ADF's facilities, NASD members operating non-exchange markets (i.e., market makers and ECNs) would have no ability to conduct their operations off of an exchange upon Nasdaq's registration as an exchange, thus eliminating the over-the-counter market. And as noted earlier, any "harmful distortions in the operation of the market" are created not by the ADF, but by Nasdaq's operation as a direct competitor to exchanges with the advantage of having the only decentralized market structure.

The Nasdaq Letter then goes on to state that "[c]ontrary to Nasdaq's competitors' contentions that competition would be squelched when SuperMontage was implemented, nothing has been further from the truth. Competition has flourished." Instinet agrees that from the perspective of competition in the over-the-counter market at least, competition is flourishing, but consistent with Instinet's position expressed during the SuperMontage approval process, and well known to the Commission, this competition in the over-the-counter market flourishes only as a result of the availability of the ADF, which Nasdaq would now propose to eliminate as an "anachronism."

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[8] 15 U.S.C. 78k-1(a)(1)(C)(ii).

[9] Rule 11Ac1-1(b)(1)(ii) under the Act, 17 CFR 240.11Ac1-1(b)(1)(ii) (requiring every national securities association to collect and process quotation information in Nasdaq-quoted and exchange-listed securities from over-the-counter market participants) and Rule 11Aa3-1(b)(1) under the Act, 17 CFR 240.11Aa3-1(b)(1) (requiring every national securities association to file a transaction reporting plan regarding over-the-counter transactions in Nasdaq-quoted and exchange-listed securities).

At the same time, however, the Nasdaq Letter's assertion that the trading of Nasdaq-quoted securities by certain exchanges is proof of competition obviating the continuing need for the ADF is not justified. The Cincinnati Stock Exchange, Inc.'s ("CSE") continued competitiveness, in being able to attract additional market participants or retain The Island ECN ("Island") as a market participant, is hampered by its inability to obtain Commission approval of its proposal to establish a decentralized market structure similar to Nasdaq.[10] The Chicago Stock Exchange, Inc.'s ("CHX") experience is inapposite as CHX participates in SuperMontage. The American Stock Exchange, LLC currently is responsible for negligible volume in Nasdaq-quoted securities. The Pacific Exchange, Inc.'s Archipelago Exchange only has begun the process of trading Nasdaq-quoted securities outside of Nasdaq. In addition, the Nasdaq Letter's statement there has been an "eight- to ten-fold increase over the number of [trades in Nasdaq-quoted securities] that were reported off of Nasdaq before SuperMontage" is simply incorrect.[11]

The remainder of the Nasdaq Letter consists of assertions that the ADF Fee Proposal permits the NASD to unfairly cross-subsidize the initial and continuing cost of the ADF's operations through the NASD's non-ADF regulatory fees. First, Nasdaq provides no evidence in support of these assertions, but simply dismisses the NASD's ability to cover its continuing operating costs through the ADF fee schedule while speculating that the NASD's regulatory fees from other activities will be utilized to support the ADF's operating costs. Second, Nasdaq's presumptions underlying its assertion regarding the ADF's need to cover its initial operating costs through the ADF fee schedule are misplaced. As noted earlier, the NASD has a statutory obligation to provide its members with a facility to enable them to trade off-exchange. Nasdaq was developed to meet this statutory obligation. Nasdaq has chosen to become a for-profit competing exchange, which leaves the NASD with the need to replace Nasdaq in the role of over-the-counter facility for its members. Consequently, the compensation NASD received in return for its interest in Nasdaq implicitly includes the costs of developing and implementing the ADF as a replacement for Nasdaq. Finally, even if there would be any cross-subsidization of the ADF's continuing operations from other NASD revenue sources, or if ADF revenues would be used cross-subsidize other NASD activities, such cross-subsidization would not appear to be inconsistent with Section 15A(b)(5) of the Act, which pertains to the equitable allocation of reasonable dues, fees, and other charges among the users of any NASD operated or controlled facility, and not among users and non-users of an NASD facility, as Nasdaq appears to argue.

[10] Securities Exchange Act Release No. 45405 (February 6, 2002), 67 FR 6558 (February 12, 2002) (File No. SR-CSE-2001-04).

[11] Island's movement of trade reporting activity from Nasdaq to the CSE, which to date accounts for the predominant share of trade reporting activity in Nasdaq-quoted securities off of Nasdaq, occurred well before the implementation of SuperMontage began in October 2002.

In conclusion, Instinet strongly supports the adoption of the ADF Fee Proposal on an immediately effective basis as the Proposal equitably allocates ADF fees among all types of ADF market participants in a manner consistent with Section 15A(b)(5) of the Act. Instinet also believes that the adoption of the proposal is consistent with Section 15A(b)(6) of the Act as it is critical to ensuring that the NASD continues to meet its obligations under the Act and the rules promulgated thereunder to provide its members trading off-exchange with quotation display and trade reporting facilities. In addition, the Proposal is essential to the NASD's continuing fulfillment of the Commission's condition to the approval of SuperMontage that the NASD provide its members with an over-the-counter alternative to their participation in SuperMontage.

Please do not hesitate to contact the undersigned at 212.310.7548 if you should have any questions regarding this matter.

Sincerely yours,

Paul Merolla
Executive Vice President and
General Counsel

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

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