

# INSTINET GROUP

January 20, 2005

Ms. Barbara Z. Sweeney  
Office of the Corporate Secretary  
NASD  
1735 K Street, N.W.  
Washington, DC 20006

Re: Notice to Members 04-80, Proposed Changes to the OATS Rules

Dear Ms. Sweeney:

Instinet Group Incorporated (“Instinet Group”) is pleased to offer its comments on NASD Notice to Members 04-80 (the “NTM”), in which the NASD seeks comment on several proposed modifications to rules regarding the NASD’s Order Audit Trail System (“OATS”), intended to enable NASD to create a more comprehensive and accurate audit trail and improve the effectiveness of NASD’s automated surveillance for potential violations of NASD rules and federal securities laws. 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<sup>1</sup> and Inet ATS, Inc. (“INET”)<sup>2</sup>.

While Instinet Group supports the underlying goal of establishing a complete, accurate order and trade audit trail, we believe that the proposals outlined by the NASD raise significant policy, competitive and operational issues and are not the best answer to the current problems that impair comprehensive surveillance. On a fundamental level, we note that many of the issues raised by the NASD are addressed in the Securities and Exchange Commission’s Concept Release Concerning Self-Regulation (“Concept

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<sup>1</sup> 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>.

<sup>2</sup> 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>.

Release”).<sup>3</sup> We believe that consideration of the NTM should be postponed until the larger issues surrounding self-regulation have been fully discussed in the context of the Concept Release and the Commission determines whether any revisions to the existing self-regulatory structure ultimately are necessary in light of such discussion.

If the NASD proceeds with its request notwithstanding the pending outcome of the Concept Release, Instinet Group has additional specific concerns with the proposals. Instinet Group questions whether a market center should be the central surveillance mechanism for brokers and other market centers with which it competes. We are also concerned about extensive duplication of audit trail reporting that would result from adoption of these proposals and the additional development and support resources that firms would need to expend to maintain multiple reporting systems. From an operational perspective, Instinet Group is concerned that the NASD’s already overtaxed systems will not be able to handle the additional burden of processing data for securities not currently reported to OATS, and that additional burdens will be placed on member firms.

#### **I. Market-wide Questions Regarding Intermarket Regulation must be Answered Prior to Implementing Specific Solutions**

The optimal mechanism for SROs to adequately regulate their members given today’s fragmented market structure has been the topic of much discussion over the past few years. In May of 2002 the General Accounting Office issued a report focused on the potentially duplicative nature of SRO regulation given the increasingly fragmented market structure.<sup>4</sup> The following year the SEC sought comment on a petition filed by Nasdaq that also addressed issues relating to the trading of securities on market centers regulated by different SROs.<sup>5</sup> Most recently, the SEC published the Concept Release, which devotes a significant portion of its discussion to intermarket surveillance and the inefficiencies of the multiple SRO model.<sup>6</sup>

Although the topics of multiple SROs and intermarket regulation have been widely discussed, the industry and regulators remain uncertain of the most effective path forward. The Concept Release requests comment on the level of inefficiency caused by multiple SROs overseeing the activities of the same members, the extent to which fragmentation has caused gaps in intermarket trading surveillance, the effectiveness of the Intermarket Surveillance Group, the industry organization created in 1983 to coordinate intermarket surveillance among the SROs, and even the efficacy of merging the New York Stock Exchange (“NYSE”) OTS and NASD OATS audit trails. In light of the ongoing nature of this discussion (the comment period for the Concept Release does

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<sup>3</sup> Securities Exchange Act Release No. 34-50700 (November 18, 2004)

<sup>4</sup> U.S. General Accounting Office Report to Congressional Committees, “Securities Markets Competition and Multiple Regulators Heighten Concern about Self-Regulation” (May 2004) (“GAO Report”)

<sup>5</sup> Concept Release: Request for Comment on Nasdaq Petition Relating to the Regulation of Nasdaq-Listed Securities, Exchange Act Release No. 47489 (May 14, 2003)

<sup>6</sup> Concept Release at 71264, 71265

not end until March 8, 2005), it is imprudent for the NASD to implement changes at this time that could become unnecessary or worse, in conflict with the ultimate approach taken by the SEC.

## **II. Specific Issues with NASD Proposal**

Although Instinet Group strongly urges the NASD to postpone implementation of the proposals outlined in the NTM in anticipation of action on the Concept Release, we outline specific concerns with the proposals here.

### ***Competitive Issues Exist when SROs Operate Competing Market Centers***

Instinet Group is concerned with an expansion of its requirement to provide order and execution information to the NASD based on competitive issues. NASD in addition to regulating market centers such as INET, operates its own market center, the ADF, and remains the largest single shareholder in NASDAQ. The NASD's ADF and NASDAQ compete directly with INET for orderflow from broker-dealers. OATS information specifies, among many other attributes of orders, the identity of the broker-dealer client that has submitted an order. We believe there are significant competitive implications if members such as INET must provide a competitor with additional information about customer activity on a competing market center.

### ***Duplication of Audit Trail Reporting Requirements will be Overly Burdensome***

The NASD's proposals call for the inclusion of information related to orders in exchange-listed securities as well as orders routed to non-members or exchanges, to enable it to perform certain automated surveillance for these securities. In addition to the competitive concerns raised above, Instinet Group believes that there will be significant burdens placed upon NASD members to comply with these provisions, creating duplicative reporting to multiple SROs. Although the NASD states that they will attempt to minimize the potential for duplicative order reporting, the various systems operated by the multiple SROs currently regulating trading of exchange-listed securities are so divergent that it would be extremely difficult for the NASD to develop a system which would avoid significant duplication of effort in order to comply with the requirement that OATS also receive this data. A comparison between OTS and OATS, for example, highlights many differences in the file formats, mechanisms of transmission of data and the nature of the reporting (OTS is on-request where OATS is a daily requirement).

The proposed requirement would also place a significant new burden on an NASD member that trades only exchange-listed securities. One of Instinet Group's broker-dealer subsidiaries, Harborview, LLC ("Harborview"), for example, is a member of both NASD and NYSE and is therefore subject to regulation by both SROs. Harborview deals exclusively with exchange-listed securities and therefore has no OATS reporting mechanism today. Under the proposed rule changes, Harborview would not

only need to maintain its current OTS, DPTR and other NYSE reporting systems, but would be required to develop new OATS reporting capabilities to provide the same information to the NASD, albeit in a slightly different format. This would be a costly undertaking from both a development and support perspective, with no appreciable surveillance or regulatory benefit.<sup>7</sup>

### ***Capacity and other Operational Concerns***

In June 2004, NASD Notice to Members 04-46 (the "Notice") was published, implementing mandatory changes to OATS reporting. As a result of this change, members must utilize more compressed reporting formats to reflect orders that are received and subsequently routed, executed or canceled in full on the same day. According to the Notice, the changes are intended to reduce the number of data records submitted by firms, in response to a recent significant increase in OATS volume. It is clear from this Notice, as well as from frequent operational issues experienced by the NASD, that the capacity of the OATS system is straining to process current volumes.

Instinet Group is therefore concerned that NASD has not adequately considered the capacity implications of implementing its proposals to expand OATS to cover exchange-listed, OTC, and Pink Sheet stocks and additional information on orders routed to non-members and exchanges as well as proprietary trading activity. Expanding INET's reporting to cover these additional items, for example, would increase its reporting volume by approximately 50%. That would result in an average increase of over 15 million records per day from INET alone. The NTM does not indicate that NASD is taking any steps to address the capacity needs that will result from these proposals. Instinet Group urges the NASD to clarify their plans in this area.

The NTM's proposal relating to additional information to be provided relating to orders routed to exchanges or non-members poses operational challenges to members. Once orders are routed, subsequent communication between the member and the destination market center or firm are generally limited to execution reports or cancellations. It is impractical to expect members to report to NASD on detailed actions such as subsequent routing since they do not have access to that information. Reporting Agent arrangements will not suffice to remedy this situation, assuming they will exist, since firms retain the ultimate responsibility for the accuracy of the data, yet will have no mechanism with which to validate the information provided to NASD by the destination market center.

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<sup>7</sup> Although NASD points out in the NTM that members can enter into reporting agent agreements with non-members or exchanges to report OATS information, it is unknown at this time whether NYSE, for example, will provide such a service or whether it would be appropriate for Instinet Group to utilize such a service. In addition, as the notice also points out, the ultimate responsibility for OATS reporting still lies with the member firm, meaning that supervisory processes for OATS would still be necessary at Harborview, LLC.

Ms. Barbara Z. Sweeney  
January 20, 2005  
Page 5

When orders are routed to non-members or exchanges, those orders become subject to the rules governing those members or exchanges. It is unclear how NASD will program its systems to take all of the different rules of all the other SROs into account when performing surveillance. For example, the short sale rule currently has different “flavors” under different SROs, and in some cases does not exist at all. It is unclear whether reporting information to NASD on these orders will trigger “false positives” when the NASD performs surveillance on those orders. If a significant number of “false positives” are generated, a burden on firms’ compliance and technology resources will be unnecessarily created. Clearly a significant effort will be required on the part of the NASD to keep track of rule changes on other SROs and keep their surveillance systems in lock step with them. Instinet Group urges NASD to clarify their plans in this area.

### **III. Conclusion**

Instinet Group believes that there are significant issues in the areas of multiple SRO regulation and surveillance of intermarket trading activity. We are pleased that the SEC has initiated the evaluation of appropriate measures to be taken to address these issues, most notably by issuing its Concept Release. Instinet Group believes that any proposals to address issues highlighted in the Concept Release should be shelved until the conclusion of the SEC’s process. The solutions to the marketwide issues addressed in the Concept Release should be solved through this inclusive process rather than by implementing an SRO-specific solution. We look forward to working with the NASD, SEC and others to improve the quality of regulation in the equity markets.

We appreciate the opportunity to comment and would be pleased to discuss any of the comments in this letter. If we can be of further assistance in this regard, please do not hesitate to contact the undersigned at 212-310-7862.

Yours Sincerely,

Deborah Mittelman  
First Vice President