SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52514)

September 27, 2005

Order Granting Exemption to Liquidnet, Inc. from Certain Provisions of Regulation ATS under the Securities Exchange Act of 1934

I. Introduction

Pursuant to Rule 301(a)(5)[1] of Regulation ATS under the Securities Exchange Act of 1934 ("Exchange Act"),[2] the Securities and Exchange Commission ("Commission"), by order, may grant an exemption, either conditionally or unconditionally, from one or more of the requirements of paragraph (b) of Regulation ATS, including subsection (b)(5) thereunder (the "Fair Access Rule"), if the Commission determines that such exemption is consistent with the public interest, the protection of investors, and the removal of impediments to, and perfection of the mechanisms of, a national market system. As discussed below, by this Order the Commission exercises its authority under Rule 301(a)(5) of Regulation ATS to conditionally exempt Liquidnet, Inc. ("Liquidnet") from certain requirements imposed by the Fair Access Rule, as recently amended in connection with the adoption of Regulation NMS.[3] This exemption shall take effect on September 28, 2005, the same date as the compliance date of the recent amendment to the Fair Access Rule.

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1 17 CFR 242.301(a)(5).

2 17 CFR 242.300 et seq.

3 See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) ("Regulation NMS Adopting Release").

II. **Background**

The activities of an alternative trading system ("ATS") are governed by Regulation ATS.[4] One provision of Regulation ATS is the Fair Access Rule, which provides, among other things, that, if an ATS accounts for a certain percentage of the average daily volume in a security over four of the preceding six months, the ATS: (1) must establish written standards for granting access to trading on its system, and (2) must not unreasonably prohibit or limit any person in respect to access to services offered by such system by applying these written standards in an unfair or discriminatory manner.[5] In connection with Regulation NMS, adopted in June 2005, the Fair Access Rule was amended to lower the fair access threshold from 20% of the average daily volume in a security to 5%.[6]

Liquidnet operates an ATS and, to comply with Regulation ATS, has, among other things, registered as a broker-dealer under Section 15(b) of the Exchange Act[7] and filed a Form ATS with the Commission. Consequently, Liquidnet is subject to the Fair Access Rule in its trading of securities in which it crosses the applicable volume threshold. Specifically, Liquidnet operates an electronic platform that allows its subscribers to enter into negotiations for the purchase and sale of large blocks of shares. Unlike most ATSs, however, Liquidnet does not

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4 Rule 3a1-1 under the Exchange Act (17 CFR 240.3a1-1) exempts an ATS from the definition of "exchange" under Section 3(a)(1) of the Exchange Act (15 U.S.C. 78c(a)(1)), and therefore the requirement to register as an exchange, if it complies with the applicable requirements of Regulation ATS, including registering as a broker-dealer under Section 15 of the Exchange Act (15 U.S.C. 17o).

5 See 17 CFR 242.301(b)(5)(A) - (B). In addition, the Fair Access Rule requires an ATS to make and keep records of all grants, denials, and limitations of access and to report that information to the Commission on Form ATS-R. See 17 CFR 242.301(b)(5)(ii)(C) - (D).

6 The Fair Access Rule applies on a security-by-security basis. See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844, 70873 (December 22, 1998) ("Regulation ATS Adopting Release").

7 15 U.S.C. 78o(b).

display quotations and does not maintain a "book" that is accessible by its membership. Rather, Liquidnet's system interacts with a subscriber's order management system to ascertain the subscriber's open trading interest and attempts to identify potential contra-side interest among other subscribers. If the system can locate interest on opposite sides, it notifies the potential buyer and seller who then can negotiate a transaction through the system's messaging facilities on an anonymous, one-to-one basis. By exposing potential trading interest anonymously and only to other subscribers, Liquidnet aims to reduce the market impact costs of trading large volumes. Liquidnet argues that it operates in a manner similar to a broker-dealer that operates a traditional block trading desk, which generally would not be subject to the Fair Access Rule.

If Liquidnet crosses the 5% threshold in a particular security, it would be required, among other things, to establish written access standards for trading in that security and would not be permitted to "unreasonably prohibit or limit any person in respect to access to services offered . . . by applying the standards . . . in an unfair or discriminatory manner."[8] Under the Fair Access Rule, Liquidnet would be prohibited from denying a membership application based on the potential trading strategies of an applicant.[9] Liquidnet, however, contends that its business model is premised on the ability to deny access to certain subscribers or potential subscribers in a manner that could be construed as unfair or discriminatory under Regulation ATS. Liquidnet caters to institutional investors, typically mutual funds and pension funds, that seek to trade large volumes with other similarly-minded institutions while minimizing the market impact of such trades. Liquidnet subscribers expect that potential counterparties will negotiate in good faith and will not use information about trading interest learned on the Liquidnet system to trade ahead of

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8 17 CFR 242.301(b)(5)(ii)(B).

9 See Regulation ATS Adopting Release, 63 FR at 70874 (noting that a denial of access might be "unreasonable" if it were "based solely on the trading strategy of a potential participant").

that interest outside the system.[10] Although Liquidnet has established written standards for granting access to trading on its system, certain of those standards may be applied by Liquidnet in a manner that may be inconsistent with the Fair Access Rule. For example, Liquidnet's access standards provide that a Liquidnet subscriber may not engage in trading activity that would be "reasonably objectionable" to the Liquidnet member community. Further, the standards provide that Liquidnet may terminate a subscriber's access if such subscriber does not take an "appropriate" level of action on matches, thereby "causing frustration" to other Liquidnet subscribers.[11]

Liquidnet has stated that, to avoid being subject to the current 20% threshold of the Fair Access Rule, it would temporarily disable trading in a particular security for a period of time if it approached the 20% fair access threshold for that security.[12] Liquidnet represents that, since its inception, it has disabled trading only once in this manner.[13] However, Liquidnet does not believe that this approach would be practical under the lower 5% fair access threshold, as it has

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10 See Letter to Jonathan G. Katz, Secretary, Commission, from Seth Merrin, Chief Executive Officer, Liquidnet, dated August 19, 2005 ("Liquidnet Exemption Request"), at 7. For example, User A could express an insincere interest in selling Security XYZ and be connected by Liquidnet with User B, who expresses sincere interest in buying a very large block of XYZ shares. User A could then refuse to negotiate with User B and buy shares of XYZ on another market, hoping that User B will drive up the price of XYZ when User B eventually executes its buy order.

11 See Letter from Theodore R. Lazo, Morgan, Lewis & Brockius LLP, to Michael Gaw, Assistant Director, Division of Market Regulation, Commission, dated August 12, 2005 (enclosing Liquidnet eligibility criteria).

12 See Liquidnet Exemption Request, at 6. Liquidnet states that the design of its software platform makes it impractical to provide open access to its system for trading only in a particular security. Therefore, Liquidnet views its alternatives as disabling trading in a security or providing open access to its system for trading in all securities, not just the security that crosses the fair access threshold. See id.

13 See id.

crossed the 5% threshold several times for several securities.[14] Accordingly, Liquidnet has requested an exemption from subsection (ii)(B) of the Fair Access Rule that would permit it to apply its access standards in a manner that might be unfair or discriminatory, thereby preserving its ability to deny access to subscribers or potential subscribers whose trading strategies, in its view, could cause institutional customers to abandon the Liquidnet system.

III. Discussion

After careful consideration and for the reasons discussed below, the Commission hereby grants Liquidnet a limited exemption from the Fair Access Rule, subject to the conditions set forth below.

The Fair Access Rule is designed to ensure that market participants have fair access to services offered by an ATS that has a significant percentage of a security's trading volume.[15] Originally 20%, the fair access threshold was lowered in connection with Regulation NMS to 5% to improve the fairness and efficiency of private linkages and facilitate the incorporation of large ATSs into the national market system.[16] Lowering the fair access threshold to 5% was consistent with the existing order display and execution access requirement of subsection (b)(3) of Regulation ATS,[17] which also is triggered at 5%.[18] However, the order display and execution

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14 Liquidnet has represented that in 2004 it crossed the 5% threshold on 74 separate occasions in a total of 44 different securities. See id.

15 See Regulation ATS Adopting Release, 63 FR at 70872.

16 See Regulation NMS Adopting Release, 70 FR at 37550.

17 17 CFR 242.301(b)(3).

18 See Regulation NMS Adopting Release, 70 FR at 37550. An ATS subject to the display and execution access requirement for a particular NMS stock is required to provide to a national securities exchange or national securities association the prices and sizes of the orders at the highest buy price and the lowest sell price for such NMS stock for inclusion in the exchange's or association's quotation data. Further, the ATS is required, with respect to any order displayed pursuant to this provision, to provide the ability to effect a

access requirement applies only to the best priced "orders" displayed to more than one person in the ATS.[19] As its business is described in the Liquidnet Exemption Request, Liquidnet does not display orders through its system to more than one person. Rather, Liquidnet surveys subscribers' order management systems, identifies potential contra-side interest, and provides an electronic platform through which subscribers may negotiate trades on an anonymous, one-to-one basis.

An unintended consequence of lowering the fair access threshold, however, is that an ATS such as Liquidnet – whose business model depends on preserving subscribers' confidence that information about their trading interest will not leak outside the system – could lose the ability to deny access to those who would leak such information. The Commission recognizes the difficulty of crafting an access standard that would not be "unfair or discriminatory" in view of Liquidnet's need to judge the likelihood of a participant's engaging in objectionable behavior. Moreover, objective evidence of a subscriber's activities might be scarce, as trading ahead of Liquidnet subscriber interest outside the Liquidnet system could be difficult to prove. Further, objective evidence obtained from observing a subscriber's behavior on the Liquidnet system might be inconclusive, at best. For example, there might be valid business reasons for failing to consummate negotiations with executions on a regular basis that do not impose market impact costs on other Liquidnet subscribers.

Based upon the foregoing, the Commission believes that granting Liquidnet a limited exemption from the Fair Access Rule is consistent with the public interest, the protection of investors, and the removal of impediments to, and perfection of the mechanisms of, a national

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transaction with such order to any broker-dealer that has access to the respective exchange or association. See 17 CFR 242.301(b)(3)(B)(ii) - (iii).

19 17 CFR 242.301(b)(3)(i)(A).

market system. The Commission notes that Liquidnet limits its business to institutional block trading and that all trades result from anonymous, one-to-one negotiations. Granting Liquidnet the limited exemptive relief specified herein should accommodate a forum in which large institutional investors can negotiate trades in a manner that limits their market impact costs, yet should not impede the functioning of the national market system. In particular, since Liquidnet does not disseminate quotations, applying the new 5% fair access threshold to Liquidnet would not further the Commission's primary policy goal in lowering the threshold, namely facilitating indirect access to the quotes of ATSs that are displaying them in the public quote stream.

Accordingly, the Commission hereby exempts Liquidnet from paragraph (b)(5)(ii)(B) of Regulation ATS so that Liquidnet may apply its access standards in a manner that may be unfair or discriminatory and thereby exclude subscribers or potential subscribers whose trading strategies may conflict with the use of Liquidnet by its primarily institutional customer base.[20] The Commission is conditioning this exemption on Liquidnet's abiding by all of the other requirements of the Fair Access Rule, including subsections (A), (C), and (D) of paragraph (b)(5)(ii). Therefore, Liquidnet will be subject to the 5% threshold with respect to the requirements to: (1) establish written standards for granting access to trading on its system;[21] (2) make and keep records of all grants, denials, and limitations of access;[22] and (3) report certain information to the Commission on Form ATS-R regarding grants, denials, and limitations of

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20 See 17 CFR 242.301(b)(5)(ii)(B). In other words, under the exemptive relief the Commission is hereby granting to Liquidnet, such a denial of access by Liquidnet would not be considered "unreasonable" under Rule 301(b)(5)(ii)(B). See Regulation ATS Adopting Release, 63 FR at 70874.

21 See 17 CFR 242.301(b)(5)(ii)(A).

22 See 17 CFR 242.301(b)(5)(ii)(C).

access.[23] The Commission believes that Liquidnet's compliance with subsections (ii)(A), (C), and (D) of the revised Fair Access Rule will allow the Commission to monitor grants, denials, and limitations of access by Liquidnet to its system in order to assess the continued advisability of this limited exemption.

In addition, if, during at least four of the preceding six calendar months, Liquidnet has 20% or more of the average daily volume in any of the securities described in the Fair Access Rule, it must cease applying its access standards in a manner that may be unfair or discriminatory and comply in full with paragraph (b)(5)(ii)(B) of Regulation ATS with respect to any such security. The Commission believes at this time that, at the 20% threshold – incorporated into the current version of the Fair Access Rule – investors' need to access an ATS's liquidity supersedes the ATS's desire to restrict access to its system. Moreover, the Commission notes that Liquidnet has approached the 20% threshold only on one previous occasion, and that Liquidnet did not believe it necessary to request relief from the Fair Access Rule until the Commission proposed to lower the fair access threshold to 5%.[24] This exemption also is conditioned on Liquidnet conducting its business substantially as it is conducted today, as described in the Liquidnet Exemption Request; any material changes in Liquidnet's business may cause the Commission to reconsider this exemption.

IV. <u>Conclusion</u>

IT IS HEREBY ORDERED, pursuant to Rule 301(a)(5) of Regulation ATS, that Liquidnet, as of August 29, 2005, shall be exempt from paragraph (b)(5)(ii)(B) of Regulation

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23 <u>See</u> 17 CFR 242.301(b)(5)(ii)(D).

24 <u>See</u> Letter to Jonathan G. Katz, Secretary, Commission, from Seth Merrin, Chief Executive Officer, Liquidnet, dated January 26, 2005; and Letter to Jonathan G. Katz, Secretary, Commission, from Seth Merrin, Chief Executive Officer, Liquidnet, dated July 2, 2004 (both letters comment on Regulation NMS and request some form of relief from the new fair access threshold if the Commission were to adopt it).

ATS to the extent that Liquidnet exceeds the 5% fair access threshold in a particular security and applies its access standards in a manner that excludes subscribers or potential subscribers whose trading strategies may operate in a manner inconsistent with Liquidnet's business model and the expectations of its primarily institutional customer base. Since Liquidnet does not disseminate quotations, applying the new 5% fair access threshold to Liquidnet would not further the Commission's primary policy goal in lowering the threshold, namely facilitating indirect access to the quotes of ATSs that are displaying them in the public quote stream. This exemption is conditioned on Liquidnet's abiding by all of the other requirements of the Fair Access Rule, including subsections (ii)(A), (C), and (D) of paragraph (b)(5), if Liquidnet exceeds the new 5% threshold in a particular security. In addition, if, during at least four of the preceding six calendar months, Liquidnet has 20% or more of the average daily volume in a particular security, it must comply in full with paragraph (b)(5)(ii)(B) of Regulation ATS with respect to that security. Finally, this exemption is conditioned on Liquidnet conducting its business substantially as it is conducted today, as described in the Liquidnet Exemption Request; any material changes in Liquidnet's business may cause the Commission to reconsider this exemption.

By the Commission.

Jonathan G. Katz
Secretary