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July 2, 2004

Jonathan G. Katz, Esq.
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: File No. S7-10-04, Proposed Regulation NMS

Dear Mr. Katz,

Liquidnet, Inc. appreciates the opportunity to comment on the proposed Regulation NMS. The Commission's recent supplemental request for comment shows that it is giving careful consideration to the suggestions of the various market participants, and we commend the Commission's approach on these difficult issues.

INTRODUCTION

The following is a summary of the key points we raise in this letter:

- Liquidnet's trading system provides an electronic venue for block trading. Liquidnet's institutional customers execute, on average, 43,048 shares per trade on Liquidnet.[1]

- By facilitating electronic block trading, Liquidnet provides significant savings to its institutional customers in the form of reduced commissions, price improvement and, most important, reduced market impact costs.

- These cost savings are passed through directly to the millions of beneficiaries of the accounts managed by these institutions.

- The ATS fair access rule, if applied to Liquidnet, would hinder Liquidnet's ability to provide cost savings to its institutional customers and, in turn, their shareholders.

- We do not believe the SEC intended to apply the fair access requirement to systems like Liquidnet.

[1] From inception (April 2001 through June 25, 2004) (US equities).

- The fair access requirement is aimed at providing access to published quotes; Liquidnet does not publish quotes.

- As an electronic block trader, Liquidnet should be exempt from the fair access provisions, like all other block traders. The regulations should not favor one model of block trading at the expense of another model – adversely affecting institutional investors' ability to choose to find the most efficient execution for their block-sized orders.

- Certain changes proposed in Regulation NMS could make it easier for institutions to execute orders through the central markets, but institutions will also continue to rely on traditional brokers and crossing systems to achieve best execution of block-sized orders.

We will also discuss at the end of this letter our views on the trade through rule and sub-penny trading.

BACKGROUND ON LIQUIDNET

Liquidnet operates an electronic block trading system. We are registered as a broker/dealer and as an alternative trading system.

Liquidnet was founded in November 1999 with a specific purpose in mind – to use technology to make block trading more efficient. Our company's mission from its founding has been to reduce the significant market impact costs associated with block trading of equity securities – which benefits our institutional customers and the individual investors whom they serve.

Liquidnet commenced trading U.S. equity securities in April 2001. We commenced trading in five European markets in November 2002. Since inception, the average execution size for U.S. securities in Liquidnet has been 43,048 shares, which is approximately 90 times the average execution size on the New York Stock Exchange.[2] This industry-leading average execution size, combined with the fact that 92% of all executions take place at or within the bid/offer spread, demonstrates that we have stayed true to our original mission – to make institutional block trading more efficient. Liquidnet, while still young, demonstrates that institutions do not have to sacrifice size for price. In fact, as discussed in more detail below, Liquidnet provides average price improvement of 1.6 cents per share, in addition to low commission rates relative to traditional block traders as well as reduced market impact costs.

Liquidnet is an execution-only trading venue. We do not do investment banking, and therefore do not provide our customers with IPOs. We do not have a research business. We do not sell our customers' mutual funds. This means an institution would use

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[2] Liquidnet average execution size from inception through June 25, 2004; NYSE average execution size of 488 shares for 2003 (NYSE Fact Book – www.nysedata.com).

Liquidnet only if it determined that we provided an efficient execution of the institution's block orders.

Our success to date is based on providing an efficient execution of our customers' block orders. As of the date of this letter, Liquidnet has 213 live institutional customers and an additional 58 firms waiting to go live. This customer base collectively manages approximately $6.2 trillion in equity assets.[3] In less than three years, these firms have traded more than 6 billion shares through Liquidnet.[4] In its most recent report, Plexus Group ranked Liquidnet as the 15th largest listed broker and 20th largest NASDAQ broker out of its universe of 1,500 institutional brokers.[5]

Through software that we provide to our institutional customers, buy-side firms are able to enter into anonymous one-on-one negotiations for the purchase and sale of large blocks of equity securities. In doing so, they avoid the costs associated with using traditional market intermediaries. These cost savings are passed on directly to the individuals who are the beneficiaries of the mutual funds, pension funds and other managed accounts on behalf of whom our institutional customers trade. In other words, the cost savings that institutions receive by using Liquidnet ultimately benefits the individual investor – including a large segment of the approximately 91million participants in pension plans and approximately 52 million participants in 401(k) plans.[6]

LIQUIDNET'S SOLUTION TO THE PROBLEM OF INSTITUTIONAL TRADING COSTS

As the Commission has pointed out in the Reg NMS release, market impact costs are a significant issue for institutional investors.[7]

Traditional markets are efficient in handling small and medium-sized orders but are not well adapted to handle institutional block-sized orders. In fact, more than 98% of trades that take place on the NYSE are for less than 10,000 shares.[8] In addition, a typical institutional order of 100,000 shares[9] is more than 200 times the average order execution size on the NYSE. If an institutional trader or a broker acting on behalf of the institutional trader sends a 100,000-share order to the floor of the NYSE or to an ECN, it would certainly create more demand than there is supply, and thus move the price of the security against the institution that placed the order. The market impact incurred is the equivalent of dropping a boulder into a pond.

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[3] Liquidnet Membership data as of June 25, 2004. Assets under management based on Big Dough Q4-2003 data.
[4] US equities only.
[5] Plexus Group report covering Q1 2003 to Q4 2003.
[6] US Department of Labor, Pension and Welfare Benefits Administration; *The Wall Street Journal* (May 2, 2003).
[7] SEC Release No. 34-40325, Regulation NMS, February 26, 2004, p. 14.
[8] NYSE Fact Book – www.nysedata.com.
[9] Speech of Wayne Wagner, Chairman of Plexus Group, a division of JPMorgan Chase, to QWAFAFEW San Francisco, March 23, 2004.

Institutions today know they incur market impact when trading stocks. They know that the simple knowledge of who they are or the size of their order will trigger different market intermediaries to take advantage of and profit from the information at the expense of that institution. Because of that process, institutions hold their order information very closely and do not expose it to the public markets. Liquidnet uses technology to provide a quantity discovery mechanism while safeguarding that information from the intermediaries or market participants who would use that information to shop the order or who profit from knowing that information at the expense of the funds' returns.

Wayne Wagner, Chairman of Plexus Group, a firm that advises buy-side institutions on trading costs, has testified before Congress that the estimated cost of these inefficiencies to institutions is approximately 157 basis points of their assets annually.[10]

Mr. Wagner also made the following recommendation during this testimony:

> *Congress and the SEC should continue to press for market innovation, especially innovations that facilitate large buyers meeting large sellers without revealing valuable information on pending trades.*

We obviously agree with this recommendation.

Liquidnet provides cost savings in three ways. First, Liquidnet charges a commission of 2 cents per share, which is low relative to traditional block traders. Second, Liquidnet customers realize an average of 1.6 cents per share in price improvement on each trade through Liquidnet, resulting in a net average cost of .4 cents per share.[11] Finally, Liquidnet reduces the market impact costs associated with dissemination of the institution's order to market intermediaries. While market impact cost savings can be difficult to quantify, we believe that this is the most significant savings provided by Liquidnet.

We also call to your attention a recent report by Elkins/McSherry, another firm that advises buy-side institutions on trading costs. Elkins/McSherry focuses on broker performance relative to VWAP. In the most recent Elkins/McSherry study using this performance measure, Liquidnet was ranked 5th least expensive broker for Listed securities and 10th least expensive broker for NASDAQ securities, respectively, out of 2,000 brokers worldwide.[12] We believe that these rankings are the result of the innovation Liquidnet has brought to institutional trading – the type of innovation that Mr. Wagner encouraged.

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[10] Testimony of Wayne H. Wagner, Chairman, Plexus Group, Senior Vice President, JPMorgan Chase & Co., before House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, March 12, 2003.

[11] Based on Liquidnet executions from Q2 2003 through Q1 2004. This price improvement is significant in light of Liquidnet's average execution size of 43,048 shares.

[12] Elkins/McSherry analysis of Liquidnet's U.S. equity executions for 2002.

APPLICABILITY OF FAIR ACCESS REQUIREMENT TO SYSTEMS LIKE LIQUIDNET

In Reg NMS, the Commission proposes to revise Reg ATS to reduce the fair access threshold from 20% to 5%. The fair access threshold applies so that if an ATS exceeds the fair access threshold in one security, the system becomes subject to the fair access requirement for all securities. To our knowledge, the Commission has provided only limited guidance as to what constitutes fair access. In the adopting release for Regulation ATS,[13] the Commission specifically states that the public display requirement "only requires alternative trading systems to publicly display subscribers' orders that are displayed to more than one other system subscriber. Thus if an alternative trading system, like some crossing systems, by its design does not display orders to other subscribers, the rules do not require those orders to be integrated into the public quote stream."

The Commission further stated in the adopting release that "alternative trading systems are not required to provide to the public quote stream orders displayed to one other alternative trading system subscriber, such as through use of a negotiation feature." Liquidnet, as a one-to-one negotiation system, only displays any order to one other system subscriber, and thus falls within this exclusion.

With respect to the fair access requirement, the adopting release excludes "those alternative trading systems that match customer orders for securities with other customer orders, at prices for those same securities established outside such system."

We believe that the public display and fair access requirements are intended to achieve the same objective – providing access to published quotes. In Reg NMS, the Commission writes that it "is proposing to lower this "fair access" threshold in Regulation ATS from 20% to 5% in order to ensure that the quotes of all significant market participants are accessible throughout the NMS." Since systems like Liquidnet do not publish quotes, we do not believe that the Commission intended to make them subject to the fair access requirement.

We request that the Commission clarify that systems that do not display quotes or orders, or that only display orders to one other system subscriber, such as through a negotiation feature, not be subject to the ATS fair access requirement.

UNFAIR TREATMENT OF NEGOTIATION SYSTEMS RELATIVE TO BLOCK TRADING DESKS

A system like Liquidnet is more similar in function to a block-trading desk attempting to cross two customer orders than it is to an ECN or an exchange. This is evidenced by Liquidnet's average execution size being approximately 110 times greater than the average execution size of the leading ECN and approximately 90 times greater than the average execution size on the New York Stock Exchange.[14]

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[13] SEC Release No. 34-40760, December 8, 1998, http://www.sec.gov/rules/final/34-40760.txt

[14] Instinet's average execution size was 380 for the period January 2, 2004 through June 18, 2004. www.instats.com.

To impose a fair access requirement on Liquidnet but not on block-trading desks puts Liquidnet at an unfair competitive disadvantage – and not just Liquidnet, but any firm that attempts to use technology to make the block-trading process more efficient. This, in turn, distorts the efficiency of the market because two systems providing essentially the same function are subject to different regulatory treatment.

If we look at Liquidnet relative to a traditional block-trading desk, there are various reasons that Liquidnet might present fewer potential concerns to a regulator. Liquidnet does not engage in investment banking. Liquidnet neither publishes nor sells research products or analytics. Liquidnet does not sell its customers' mutual funds. We also do not trade as principal, so we do not trade against our customers. All of these areas of potential conflict are simply not present with Liquidnet. In addition, Liquidnet provides a full audit trail of every trading event, including indications, orders, negotiations and executions. Liquidnet also executes all trades as agency crosses, so the execution costs are more transparent to the customer.

That being said, we are not asking for favorable treatment relative to block-trading desks. We are just asking that we not be unfairly disadvantaged. It would be neither fair – nor realistic – to require a block desk trader who is negotiating an order between two institutional customers to publicly display the institutions' bids and offers for everyone to see,[15] nor has the SEC proposed this.

We are further concerned about the meaning of fair access and its applicability to Liquidnet. Our success comes from the ability to attract long-term investors, usually mutual or pension funds, who are seeking to trade large volumes with other similarly-minded investors. These institutions have seen their ability to trade efficiently and cost-effectively impeded when confidential information about the size of their potential trades is leaked into the market. These long-term investors are comfortable with Liquidnet because they know their information will be kept confidential, and they will encounter other institutions in Liquidnet who have similar positions and similar confidentiality requirements. We have designed our subscriber standards to meet these requirements. If we were required to open our system to those who do not have the ability to execute block-sized orders or to those who might use the information about the potential size of transactions to gain an advantage in trading, it would compromise our users and work against the benefits that the system provides.

We would like to express one final point on this issue. Liquidnet is only one example of an electronic crossing system. Other crossing systems exist today (e.g. ITG's POSIT) or may arise in the future. For the institutional buy-side firm, such competition is good and will provide them with more tools and efficient methods to execute their block trades. Such efficiencies ultimately benefit the individual investor whose account is managed by those institutions. The Commission should not impose regulations that deter this type of innovation.

[15] We discuss this further in the next section.

UNFAIR TREATMENT OF NEGOTIATION SYSTEMS RELATIVE TO POSIT

If the SEC's fair access requirement were applied to Liquidnet, it would be unfairly discriminatory since the fair access requirement does not apply to a system, like POSIT, which is a competitor of Liquidnet. We do not see any policy reason for making this distinction.

CONTINUING NEED FOR CROSSING SYSTEMS

Certain changes proposed in Regulation NMS could make it easier for institutions to execute orders in the central markets, but institutions will need to continue to rely on traditional brokers and crossing systems to achieve best execution of block-sized orders.

An institution has three basic methods for executing block orders. Each of these methods has advantages and each has drawbacks, but, to best fulfill its fiduciary obligations, the institution needs all three methods.

The first method is direct electronic access to a market, such as an exchange or ECN. An ECN preserves anonymity and can provide fast executions, but it is typically better suited for executing small to mid-size orders. This is evidenced by the following comparison of average execution sizes on Instinet, NASDAQ and Liquidnet:

- Instinet - 388 shares[16]
- NASDAQ – 579 shares[17]
- Liquidnet – 43,048 shares[18]

Using an ECN, an institution would have to break up an order into small pieces, and the succession of multiple small orders can move the market against the institution.

Assume that an institution has a limit order to buy 500,000 shares of a security. The market is showing a total of 5,000 shares to sell across multiple offers within the institution's limit. If the institution were to execute against these offers, it would still be looking to buy 495,000 shares. In the meantime, the institution has sent a clear signal to the market that there is a buyer out there, which will move the market against the institution. In addition, the market may have moved away from the institution's limit price during the time it took to execute these multiple trades. Now the bulk of the institution's order – some 495,000 shares – will not enter the market.

A second method available to the institution is to have an intermediary "work" the order for the institution. For example, the institution can transmit all or a portion of the order to a block trading desk to execute against the institution or to work the order on behalf of

[16] Instinet's average execution size was 380 for the period January 2, 2004 through June 18, 2004. www.instats.com.
[17] For 2003. www.marketdata.nasdaq.com.
[18] From inception through June 25, 2004.

the institution. In many cases, the block-trading desk may be the only way to find a natural contra on the other side. When a block-trading desk receives an order, the trader at the block-trading desk often attempts to find a natural contra through advertising the order and by phone calls to other market participants. This is where information leakage originates. When the market is clued in that there is a big buyer or seller in a name, the result is adverse price movement in that name.

A third method available to the institution is a crossing or continuous negotiation system, like POSIT or Liquidnet. We refer to these as crossing systems. Through these crossing systems, institutions are able to find a natural contra for executing a large block without incurring the market impact costs associated with using traditional market intermediaries. Crossing systems also have disadvantages. A customer might not find a match for an order or indication that it provides to the crossing system. Liquidnet, for example, finds matches on approximately 20 – 25% of our customers' orders. However, for those orders where Liquidnet finds a natural match, we provide a great value to the institution in the form of reduced transaction costs.

To achieve best execution for its accounts, an institution must have all three execution methods available. Notwithstanding potentially beneficial changes in market structure that could result from the adoption of Regulation NMS, we are concerned that the SEC's proposal on fair access, if applied to systems like Liquidnet, would limit institutions in their ability to benefit from the transaction costs savings afforded by crossing systems.

We would also like to express our views on two other proposals in Reg NMS: sub-penny pricing and the trade through rule.

SUB-PENNY PRICING

Liquidnet supports the Commission's proposal prohibiting market participants from accepting, ranking or displaying orders, quotes or indications of interest in sub-pennies.

Liquidnet also supports the Commission's statement in Regulation NMS that "a system that accepted unpriced orders that were then matched at the midpoint of the NBBO would not violate the proposed rule even through resulting executions could occur in share prices of less than one cent." We believe that these types of unpriced orders do not give rise to the types of abuses the Commission is attempting to address in the prohibition on sub-penny pricing.

Liquidnet would also propose another exception to the prohibition on sub-penny pricing, based on principles similar to the exception for unpriced orders. In Liquidnet, traders submit priced bids and offers, often at the mid-point. In fact, 48% of all Liquidnet executions are at the mid-point of the NBBO. This results in price improvement for both institutions participating in the negotiation. In Liquidnet, if the spread is an odd number (for example, $10.00 - $10.03), the trader often submits a bid or offer that is at a half-penny increment (in this example, $10.015). Where the spread is only one cent (for example, $10.00 - $10.01), it is even more likely that the trader will want to submit at the mid (in this case, $10.005).

We propose that the SEC permit orders at half-penny increments for one-to-one negotiation systems like Liquidnet. In a one-to-one negotiation system, the types of sub-penny pricing abuses that the SEC is trying to prevent are not applicable, because any orders are only seen by the two negotiating parties. We note that on a 43,048-share execution (which is the average execution size in Liquidnet since inception), price improvement of .5 cents per share would result in an average cost savings to the institution of $215 per trade.

TRADE THROUGH RULE; OPT OUT

We have considered the arguments for and against the trade through rule and the opt out proposal. We understand the value of a trade through rule, specifically in an environment where institutions can trade through non-automated markets without restriction and performance standards are imposed on automated markets. On the other hand, we recognize that institutions might want flexibility, particularly when attempting to move a block-sized order, to opt out of the trade through requirement.

We believe that we can provide value to our customers whether or not a trade through rule is implemented and whether or not an opt out is provided. We do recommend, however, that if an opt out is provided, institutions have the right to opt out on a global basis. We are concerned that an order-by-order opt out could interfere with the trading process for the institutional trader.

We would also recommend that the SEC adopt two specific exceptions to the trade through rule.

The first proposed exception would apply to one-to-one negotiation systems like Liquidnet. In our system, a trader could submit a bid or offer to another trader during a negotiation that is within the spread at the time of the bid or offer but moves outside the spread by the time the bid or offer is accepted. We are concerned that the trade through rule applied in this situation would cause frustration for the institutional trader. Accordingly, if a trade-through rule were adopted, we would request that for a one-to-one negotiation system, the system be required to prohibit any bid or offer outside the spread at the time the bid or offer is submitted, but be permitted to execute the trade if the bid or offer moves outside the spread as of the time the bid or offer is accepted by the counter-party.

The London Stock Exchange has recently approved this type of proposal with respect to the LSE's trade-through restrictions. In an interpretive letter issued to Liquidnet, the LSE wrote:

> "The point or execution (and in turn the trade reporting time) is when the Liquidnet price has been accepted by both parties. Given that the execution can

> only be at most 40 seconds later than when the price was originally prepared in accordance with the aforementioned rules, we are satisfied that this would not be considered a breach."

We would also request that the SEC consider an exclusion from the trade through rule for block-sized orders. The need for differing treatment of block-sized orders has been recognized in other contexts – for example, in relation to the SEC's limit order display rule and under various other SEC and NYSE rules.[19] We would recommend that, for the purpose of the proposed exemption, a block be defined as 10,000 shares. We acknowledge that it is easier to execute 10,000 shares of a liquid security than an illiquid security, but we believe that an across-the-board standard would have the advantage of being less burdensome to implement. In the Reg NMS proposing release the Commission writes that "an exception for block trades may not be necessary because its [the Commission's] proposed exception to the trade-through rule to allow a customer, or broker-dealer trading for its own account, to provide informed consent to having its order executed without the protection of the rule would be available to a customer or broker-dealer that wishes to execute a block trade." We believe that an exclusion for block-sized orders would be appropriate if the Commission does not allow a global opt out for institutions.

Conclusion

We would again like to thank the Commission for the opportunity to present our views. Liquidnet has demonstrated that there is a way for institutions to trade institutional-sized orders without the market impact costs associated with disseminating information about these orders to traditional market intermediaries.

Liquidnet is an experiment that has proven its value, as evident by our three-year track record, by our continually growing customer base, and by the increasing volume of shares that are executed through our system every day. But the issue here is not just about Liquidnet. It is about allowing innovative trading venues such as Liquidnet to continue to serve the institutional marketplace. Such venues exist only because they provide a tangible execution cost savings to the institutions that use them. Such savings are reflected in a fund's performance and, as a result, benefit the individual investor.

We applaud the Commission's efforts to bring efficiencies to the markets. We recognize the difficulties the Commission faces in creating regulations that meet the needs of both the institutional and the retail investor. We are encouraged that, in the Reg NMS release, the Commission has recognized the different requirements of institutional and retail investors within a common market structure. To avoid undue harm to one constituency versus the other, these differences need to be reflected in the regulations that are adopted.

[19] See, for example, SEC Rules 11Ac1-4 and 10b-18 and NYSE Rule 72.

We look forward to working with the Commission to create effective guidelines that are a benefit to all.

Very truly yours,

Seth Merrin
Chief Executive Officer