

February 9, 2010

By e-mail

Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: File Number S7-04-10
Purchases of Certain Equity Securities by the Issuer and Others
Release No. 34-61414

Ladies and Gentlemen,

Liquidnet, Inc. appreciates the opportunity to comment on the Securities and Exchange Commission's rule proposal on "Purchase of Certain Equity Securities by the Issuer and Others" (the "proposing release").¹ Liquidnet agrees with the Commission that the proposed amendments will clarify and modernize the safe harbor provisions of Rule 10b-18 under the Securities Exchange Act of 1934 (the "Exchange Act") in light of market developments since Rule 10b-18's adoption in 1982.²

In this comment letter we focus specifically on the Commission's discussion of whether to except passive pricing mechanisms from the rule's price condition. The Commission writes in the proposing release:

"We believe it may be appropriate to expand the safe harbor to permit an issuer to submit a buy order that is 'pegged' to the mid-point of the NBBO at the time of execution (a 'mid-peg' order) where the issuer's mid-peg order is matched and executed against a sell order that also is pegged to the mid-point of the NBBO at the time of execution, provided certain criteria are met, as discussed below."³

We support an exception for issuer repurchases executed at the mid-point between the highest quoted bid price and the lowest quoted offer price in the market at the time of execution. We refer to these executions as "mid-peg executions" because the execution price is pegged to the national best bid and offer ("NBBO") in the market at the time of execution.

¹ Securities Exchange Act Release No. 34-61414, "Purchase of Certain Equity Securities by the Issuer and Others", File No. S7-04-10, January 26, 2010. ("Proposing Release")

² Proposing Release, p. 1.

³ Proposing Release, p. 23.

We support an exception for mid-peg executions for the following reasons:

- Issuer repurchases provide significant benefits for issuers and investors and contribute to efficient allocation of capital within our economy. An exception for mid-peg executions will provide greater flexibility for issuers in effecting repurchases, thereby promoting these benefits for issuers, investors and the economy.
- An exception for mid-peg executions will reduce the market impact costs to issuers in effecting repurchases.
- By reducing market impact costs to issuers, mid-peg executions promote an important objective of the Rule 10b-18 safe harbor, which is to deter run-ups in the stock price when an issuer effects stock repurchases.
- Mid-peg executions do not present the concerns that Rule 10b-18 seeks to address because mid-peg executions do not signal potential price increases to the market.

We discuss each of these points in more detail below.

Policy benefits of issuer repurchases

In a journal article on stock repurchases cited in the proposing release,⁴ Gustavo Grullon and David L. Ikenberry identify the following policy benefits of issuer stock repurchases:

1. Agency costs of free cash flow

Grullon and Ikenberry write:

“For some managers in some circumstances, the perks of managing a larger, more influential organization are likely to outweigh the benefits of having satisfied shareholders. The costs that arise from this conflict between growth and value maximization are known in finance theory as agency costs – or, more specifically, as the agency costs of ‘free cash flow’.

....

The free cash flow hypothesis suggests that repurchase announcements are likely to be good news for the simple reason that they reduce management’s ability to divert capital to uses that are not in the best interest of shareholders.”⁵

Repurchases benefit investors by helping to address the agency costs of free cash flow.

⁴ Gustavo Grullon and David L. Ikenberry Rice University, “What do we know about stock repurchases”, Journal Of Applied Corporate Finance, Volume 13, Number 1 (Spring 2000). (“Grullon and Ikenberry”)

⁵ Grullon and Ikenberry, pp. 38-39.

2. Capital market allocation

Grullon and Ikenberry write:

“A central premise of how capital is allocated in a free economy is that corporations should consider returning capital to shareholders when they have run out of value-adding investment opportunities. Shareholders are then free to reallocate this capital to other more productive uses.

...

Viewed in this light, although repurchases may have the effect of shrinking the size of an organization, they are certainly not undesirable or unhealthy, nor should they be viewed as a sign of managerial failure or lack of imagination. They are essential to any dynamic economy that hopes to have voluntary reallocations of capital from the ‘old’ to the ‘new’ economy.”⁶

Share repurchases help investors allocate investment capital more efficiently.

3. Dividend substitution

Grullon and Ikenberry note that stock repurchases can function as an alternative to special dividends. They write that “stock repurchases, because of their flexibility, might offer firms another means of distributing their ‘lumpy’ non-recurring cash flows.”⁷

4. Capital structure adjustments

According to Grullon and Ikenberry, stock repurchases also help corporations adjust their debt-to-equity ratios, particularly to adjust for dilution in connection with DRIPs (dividend reinvestment plans) and issuances under employees incentive compensation plans.

Grullon and Ikenberry note:

“This need of companies to issue additional shares comes from a variety of sources and is more or less continuous. To the extent that companies do not repurchase stock, each of these activities has the effect of a small equity offering. The impact on capital structure of these issuance

⁶ Grullon and Ikenberry, pp. 39-40.

⁷ Grullon and Ikenberry, p. 40.

commitments can be substantial. Left unchecked, the firm is effectively decreasing its leverage over time.”⁸

Reducing trading costs for issuers

An issuer should have the ability to execute repurchases in a manner that protects the confidentiality of the issuer’s order information from market intermediaries who can take advantage of that order information to the detriment of the issuer. If market intermediaries can detect an issuer repurchase, they can purchase shares ahead of the issuer and sell back to the issuer at a higher price, resulting in a higher purchase price for the issuer. If the issuer can protect its order information, it means a lower total purchasing cost for the issuer. In addition, it reinforces the objective of protecting against an artificial rise in the stock price, which is the ultimate goal of Rule 10b-18.⁹

Because of the complexity involved in complying with the current Rule 10b-18 safe harbor, issuers often outsource the function to broker-dealers who take responsibility for compliance with the price and other conditions of Rule 10b-18. This presents the risk of information dissemination, as described in the preceding paragraph. The proposed mid-peg exception would provide issuers greater flexibility in how they interact with the market and protect their order information.

Facilitating direct interaction between issuers and end-investors

With mid-peg orders, issuers can interact more directly with the market and are less reliant on broker-dealer intermediaries whose participation can present the risk of information dissemination. This means a greater ability for issuers and end-investors to interact directly with each other in a confidential manner, providing reduced market impact for issuers and price improvement for both sides. This is a benefit for issuers and end-investors.

Preventing manipulation

In many respects the objectives for Rule 10b-18 and the objectives for the price test for short sales proposed by the Commission last year¹⁰ are the same, except in reverse. The key objective of the short sale price test is to deter short sellers from manipulating stock prices downward; the key objective of Rule 10b-18 is to deter issuers from manipulating stock prices upward.

The Commission writes in the proposing release for the short sale rule proposal,

⁸ Grullon and Ikenberry, p. 41.

⁹ Technically, it is the anti-manipulation provisions of the Exchange Act that are designed to prevent manipulation, and not Rule 10b-18. See, Proposing Release, p.4. Rule 10b-18 is designed to provide a safe harbor to permit issuer repurchases, subject to conditions that seek to prevent manipulative conduct.

¹⁰ Securities and Exchange Commission Release No. 34-59748, “Amendments to Regulation SHO”, File No. S7-08-09, April 10, 2009. (“Short Sale Rule Proposal”)

“Although short selling serves useful market purposes, it also may be used to illegally manipulate stock prices. One example is the ‘bear raid’ where an equity security is sold short in an effort to drive down the price of the security by creating an imbalance of sell-side interest. This unrestricted short selling could exacerbate a declining market in a security by increasing pressure from the sell-side, eliminating bids, and causing a further reduction in the price of a security by creating an appearance that the security price is falling for fundamental reasons, when the decline, or the speed of the decline, is being driven by other factors.”¹¹

As noted by the Commission, one potential concern with respect to short selling activity is that it could lead to increased selling pressure, which, in turn, could cause a reduction in the security price. Stating this in reverse, a potential concern with respect to issuer repurchases is that such activity could lead to increased buying pressure, which, in turn, could cause a rise in the stock price. This concern would apply equally to other types of issuer repurchases that would be included within the safe harbor of Rule 10b-18 – for example, posting and purchasing at the best bid price in the market – so we do not believe that this concern alone (the mere fact that an issuer is repurchasing stock) would be a basis for excluding mid-peg purchases from the safe harbor of Rule 10b-18.

A second potential concern noted by the Commission with respect to short selling activity is that it could eliminate bids, causing a reduction in the price of the security. Stating this in reverse, a potential concern with respect to issuer repurchases is that they could eliminate offers (sometimes described as “taking out offers”), causing an increase in the price of the security. Since executions at the mid-point do not eliminate offers, we do not believe that this concern would apply.

A third potential concern with respect to short sale activity is that when short sell executions occur at the bid, it could evidence an aggressive seller or that selling interest is more aggressive than buying interest. Taking this in reverse, when issuer purchases occur at the offer, it could evidence an aggressive buyer or that buying interest is more aggressive than selling interest. However, executions at the mid-point are neutral in this regard and do not evidence that buying interest is more aggressive than selling interest, nor do they evidence that selling interest is more aggressive than buying interest.

A fourth potential concern with respect to short selling activity is that posting a large sell order at the offer could evidence an aggressive seller. Taking this in reverse, an issuer could trigger an upward price movement by posting a large order at the bid. Submitting a mid-peg order

¹¹ Short Sale Rule Proposal, pp. 10-11.

provides an alternative to posting an order the bid. It could be argued, in fact, that posting a large order at the bid, which is permitted under the Rule 10b-18 safe harbor, presents a greater risk of upward price movement than a mid-peg order.

Mid-peg exception – point-in-time and continuous crossing systems

In discussing a possible exception for mid-peg executions, the Commission refers to a no-action letter relating to a since rescinded short sale price test. The no-action letter was issued to ITG on April 23, 2003.¹² Implicit in the Commission's reference to the ITG no-action letter is the Commission's underlying assumption that the policy concerns under the short sale rule and Rule 10b-18 are somewhat analogous. We agree with this underlying assumption.

The ITG system described in the no-action letter is a point-in-time crossing system where crosses are executed at a random time during specific one-minute time intervals throughout the day. The execution price is determined by ITG's computer systems by randomly selecting a time during the one-minute interval and pricing the cross at the mid-point of the NBBO at that time. Because the random execution time and price are not determined until the one-minute time interval has elapsed, the execution price could be outside the NBBO in effect as of the time the execution price has been determined.

Prior and subsequent to the time of the ITG no-action letter, exchanges and alternative trading systems have developed continuous crossing systems that allow executions to occur at the mid-point in real-time. For example, the three largest exchanges (NYSE Arca, NASDAQ OMX and BATS) and the largest electronic communications network (DirectEdge) all provide functionality for continuous execution of mid-peg orders.¹³ These executions, by definition, are priced within the NBBO at the time of execution.

Because of the differences between point-in-time and continuous crossing systems, and particularly the fact that executions in point-in-time systems can occur outside the NBBO at the time the execution price is finally determined while executions in continuous crossing systems by definition occur within the NBBO at the time of execution, we recommend that the Commission adopt separate exceptions for point-in-time and real-time crossing systems. We recommend that the conditions for each exemption be tailored based on the policy issues presented by each type of system.

¹² Letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, SEC, to Andre E. Owens, Schiff Hardin & Waite, dated April 23, 2003 (granting exemptive relief from former Rule 10a-1 for trades executed through an alternative trading system that matches buying and selling interest among institutional investors and broker-dealers at various set times during the day). ("ITG No-Action Letter")

¹³ See: NYSE Arca Order Type Guide (<http://www.nyse.com/equities/nysearcaequities/1157018931913.html>) (Mid-Point Passive Liquidity (MPL) Order); NASDAQ Order Type Guide (http://www.nasdaqtrader.com/content/ProductsServices/Trading/Workstation/rash_strategy.pdf) (Mid-Point Peg); BATS User's Manual (<http://www.sec.gov/rules/other/2010/batsy/batsexchusermanual.pdf>) (Mid-Point Pegged Orders); and Direct Edge Guide to Order Types (<http://www.directedge.com/Portals/0/docs/20090924NextGenGuidetoOrderTypes.pdf>) (Midpoint Pegged Orders). (accessed February 8, 2010)

Conditions for a mid-peg exception

Since we operate a continuous crossing system, and not a point-in-time crossing system, our focus is on a proposed exception for continuous crossing systems. Even though we do not operate a point-in-time crossing system, we support a separate exception for point-in-time crossing systems for the same policy reasons that we support an exception for continuous crossing systems.

In reviewing the conditions proposed by the Commission, we consider how they should apply to a continuous crossing system.

(i) *Matches occur at an externally derived price within the existing market and above the current national best bid*

This is the most important condition for the exception, and we believe that this condition could be further restricted to require that executions occur at the mid-point of the NBBO. This would address the potential risk that an execution above the mid-point could reflect that buying interest is more aggressive than selling interest.¹⁴

(ii) *Sellers and purchasers are not assured of receiving a matching order*

If this condition means that there is no assurance of an execution prior to the actual time of execution, we do not object to this condition. If this condition requires that executions occur at a randomly selected time within a pre-specified time interval, we believe this condition would be specific to the ITG no-action letter and point-in-time crossing systems¹⁵ and would not be applicable for continuous crossing systems.

(iii) *Sellers and purchasers do not know when a match will occur*

Like the previous condition, this condition appears to be specific to the ITG no-action letter and point-in-time crossing systems.

Consistent with our comment above with respect to condition (ii), if condition (iii) means that the parties have no assurance of the execution time prior to the actual time of execution, we do not object to this condition. If condition (iii) means that execution times must be randomized, we would not support such a condition as it would exclude continuous crossing systems from eligibility under Rule 10b-18. Since we believe that continuous crossing systems that execute trades at the mid-point of the NBBO can reduce trading costs for issuer repurchases while helping to prevent artificial price rises that occur when market intermediaries take advantage of their knowledge of issuer orders, we believe that mid-peg executions by continuous crossing systems should be included within the safe harbor of Rule 10b-18.

¹⁴ We are not suggesting that other types of exceptions would not be appropriate. Rather, we are identifying the set of conditions that we believe would be appropriate for a mid-peg exception.

¹⁵ ITG No-Action Letter, p. 3.

(iv) Persons relying on the exception are not represented in the primary market offer or otherwise influence the primary market bid or offer at the time of the transaction

For condition (iv) we assume that the Commission means “primary market bid” and not “primary market offer”. Condition (iv) would not affect Liquidnet, but we note that the exchanges typically allow customers to submit multiple order types at the same time so a buyer could post a displayed bid at the best bid while simultaneously submitting a non-displayed buy order to execute at the mid-point.¹⁶ We believe that this should be permitted under the safe harbor.

(v) Transactions in the electronic trading system are not made for the purpose of creating actual, or apparent, active trading in, or depressing or otherwise manipulating the price of, any security

We agree that this should be a condition of the exemption, except that “depressing” should be changed to “increasing”.

(vi) The covered security qualifies as an “actively-traded security” (as defined in Rule 101(c)(1) of Regulation M)

We do not object to this condition. The Commission could consider providing flexibility so that at some point in the future, if the rule change has been in effect for some period of time, the Commission would have the ability to modify this condition without a new rule filing.

(vii) During the period of time in which the electronic trading system may match buying and selling interest, there is no solicitation of customer orders, or any communication with customers that the match has not yet occurred

Like conditions (ii) and (iii) above, this condition (vii) appears to be specific to the ITG no-action letter, which involved a periodic point-in-time cross with a randomized execution time. Condition (vii) does not seem applicable to continuous crossing systems, where an execution can occur at any time through the day.

Our particular concern with condition (vii) relates to the restriction on “communication with customers that the match has not yet occurred.” We believe that customers have the right to know whether their orders have or have not yet been executed. This condition could make sense with respect to point-in-time crossing systems where the execution time is randomized within a specific time interval, but we do not believe it would make sense for continuous crossing systems.

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As specifically discussed above, several of the possible conditions identified by the Commission are taken from the ITG no-action letter, which was issued based on Exchange Act Rule 10a-1.

¹⁶ See: NYSE Arca Order Types Fact Sheet (http://www.nyse.com/pdfs/fact_sheet_nyse_orders.pdf) (limit order and dark reserve order). (accessed February 8, 2010)

Rule 10a-1 and its associated price test have since been rescinded, and the Commission has since proposed, and may soon adopt, a new price test.¹⁷ Since, as noted above, the short sale rule and the price condition under Rule 10b-18 can be seen as two sides of the same coin, if the Commission considers it appropriate to look to the short sale rule by analogy, we think it is more relevant for the Commission to consider the most recent price test proposed by the Commission, as opposed to a price test that the Commission has rescinded. This most recently proposed price test would permit execution of mid-peg orders in real-time crossing systems.

Special trade modifier

The Commission writes in the release:

“Although purchases effected using mid-point NBBO pricing algorithms may be passively priced, such purchases are not reported using any special trade modifier to indicate to the market that they are priced according to a special formula and, therefore, may be away from the quoted price of the stock at the time of execution.”¹⁸

We believe this concern also is specific to the ITG no-action letter and point-in-time crossing systems, which involved execution of trades “priced according to a special formula” that “may be away from the quoted price of the stock at the time of execution.”¹⁹ In contrast, executions in continuous crossing systems are done at the mid-point of the NBBO at the time of execution, so, by definition, they are within the quoted price of the stock at the time of execution. Accordingly, this concern would not apply to continuous crossing systems like Liquidnet.

We would envision that the mid-peg exception would apply only to trades executed at the mid-point of the NBBO at the time of execution, so we do not believe that a special trade modifier would be required for purposes of the mid-peg exception.

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We would like to thank the Commission for the opportunity to comment on this proposal.

Very truly yours,



Howard Meyerson
General Counsel

¹⁷ This price test, which has been proposed by the Commission but not adopted, might apply at all times or after a specified reduction in the stock price. Short Sale Rule Proposal.

¹⁸ Proposing Release, pp. 24-25.

¹⁹ Proposing Release, p. 25.