SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53193)

January 30, 2006

Order Granting Exemption to Liquidnet, Inc. from Certain Provisions of Rule 612 of Regulation NMS under the Securities Exchange Act of 1934

I.   Introduction

Pursuant to Rule 612(c) of Regulation NMS[1] under the Securities Exchange Act of 1934 ("Exchange Act"),[2] the Securities and Exchange Commission ("Commission"), by order, may exempt from the provisions of Rule 612, either unconditionally or on specified terms and conditions, any person, security, quotation, or order (or any class or classes of persons, securities, quotations, or orders) if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors. As discussed further below, by this Order, the Commission exercises its authority under Rule 612(c) to conditionally exempt Liquidnet, Inc. ("Liquidnet") from certain requirements imposed by Rule 612(a) of Regulation NMS (the "Sub-Penny Rule"). This exemption shall take effect on January 31, 2006, the same date as the compliance date of the Sub-Penny Rule.[3]

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[1]   17 CFR 242.600 et seq. See also Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) ("Regulation NMS Adopting Release").

[2]   17 CFR 242.612(c).

[3]   See Securities Exchange Act Release No. 52196 (August 2, 2005), 70 FR 45529 (August 8, 2005) (extension of the compliance date of the Sub-Penny Rule from August 29, 2005 to January 31, 2006). See also Regulation NMS Adopting Release, 70 FR at 37576 (setting forth the effective dates and compliance dates of the various portions of Regulation NMS).

II.   **Background**

Rule 612 of Regulation NMS[4] governs sub-penny quoting of national market system ("NMS") stocks.[5] As of January 31, 2006, the Sub-Penny Rule will prohibit a national securities exchange, national securities association, alternative trading system ("ATS"), vendor, or broker-dealer from displaying, ranking, or accepting a bid or offer, an order, quotation, or indication of interest in any NMS stock that is priced in an increment smaller than $0.01 per share, unless the price of the bid or offer, order, or indication of interest is priced less than $1.00 per share.[6] The Sub-Penny Rule, however, does not prohibit a sub-penny execution, including one resulting from a midpoint or volume-weighted trading algorithm, so long as the execution does not result from an impermissible sub-penny order or quotation.[7] The Sub-Penny Rule is designed, among other things, to inhibit a market participant from gaining execution priority over a competing limit order by an economically insignificant amount.[8]

Liquidnet has filed as an ATS and, as such, has registered as a broker-dealer pursuant to Section 15(b) of the Exchange Act[9] and filed a Form ATS with the Commission. Liquidnet operates an electronic platform that allows its subscribers to negotiate purchases and sales of large blocks of shares. Liquidnet's system scans the order management system of each subscriber to identify trading interest that might match that of another Liquidnet subscriber, and

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[4]   17 CFR 242.612.

[5]   An NMS stock is any non-option security for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan. See 17 CFR 242.600(b)(46) and (b)(47).

[6]   If the bid or offer, order, or indication of interest is priced less than $1.00 per share, the minimum allowable increment is $0.0001 per share. See 17 CFR 242.612(b).

[7]   See Regulation NMS Adopting Release, 70 FR at 37556. See infra text accompanying notes 16-17.

[8]   See Regulation NMS Adopting Release, 70 FR at 37551.

[9]   15 U.S.C. 78o(b).

when it identifies a potential match it notifies the potential buyer and seller, who then can

negotiate a transaction through Liquidnet's messaging facilities on a direct, one-to-one basis.[10]

When commencing a negotiation, a Liquidnet subscriber would enter certain information

into the Liquidnet system (e.g., ticker symbol, size, and price).[11] In lieu of manually entering a

price, a Liquidnet subscriber desiring to execute a trade at the midpoint can click the "mid"

button on the Liquidnet system to bid or offer at the current midpoint between the security's

national best bid and offer ("NBBO").[12] After clicking "mid," the system would determine the

then-existing midpoint price and populate that price in a text field seen by the subscriber on the

next screen. If the NBBO at that moment were an odd number of cents wide (e.g., $10.00 x

10.01), the price of the order would be in a sub-penny increment (i.e., $10.005). After reviewing

the second screen, the subscriber could click "submit," which would transmit the firm, priced

order to the potential counterparty, and the counterparty could accept, reject, or make a counter-

offer.[13]

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[10]   See Letter to Nancy Morris, Secretary, Commission, from Seth Merrin, Chief Executive
Officer, Liquidnet, dated January 12, 2006, at 2-3 ("Liquidnet Exemption Request").

[11]   Liquidnet has undertaken to prohibit its subscribers from manually entering bids and
offers in a sub-penny increment in accordance with Rule 612. See id. at 5.

[12]   See id. at 4-5. Liquidnet reports that its subscribers prefer to bid, offer, and trade in
Liquidnet at the midpoint of the NBBO. See id. at 4. Liquidnet notes that for 2005,
approximately 55% of all Liquidnet executions have been at the midpoint of the NBBO.
See id. Further, Liquidnet reports that approximately 37% of bids and offers submitted
during Liquidnet negotiations during 2005 were at a half-penny increment. See id. at 4-5.

[13]   Due to delays in the order sender reviewing the second screen and in the potential
counterparty deciding whether to accept the order, the trade price might not be the actual
midpoint at the time of execution. See id. at 5. For example, assume the order sender
clicks "mid" and the second screen appears with a price of $10.005 at T=0. The order
sender reviews the screen and hits "submit" at T+3 seconds. At T+4 seconds, the NBBO
widens to $10.00 x $10.02, so the true midpoint is now $10.01, rather than $10.005.
However, the order being viewed by the potential counterparty is still priced at $10.005.
If that person accepts the order at T+8 seconds, the price of the execution will be
$10.005. The Commission notes that in a situation where, through use of the midpoint

The Liquidnet system does not automatically execute a bid or offer at the midpoint price. Rather, the system takes the additional step of allowing the two negotiating subscribers to view the actual price at which the trade would occur (if accepted). These "mid" quotes could be priced in a sub-penny amount (i.e., $x.xx5) and, in the absence of an exemption, would be prohibited by the Sub-Penny Rule. Therefore, Liquidnet has requested a limited exemption from the Sub-Penny Rule that would allow it to accept from one subscriber and display to another an order priced in a sub-penny increment that is triggered by use of the system's "midpoint functionality" described above.[14]

III. Discussion

After careful consideration, the Commission hereby grants Liquidnet a limited exemption from the Sub-Penny Rule, subject to the conditions set forth below. The Commission believes that exempting Liquidnet from the Sub-Penny Rule with respect to orders generated by Liquidnet's midpoint functionality is necessary or appropriate in the public interest, and is consistent with the protection of investors.

The Sub-Penny Rule was designed, among other things, to limit the ability of a market participant to gain execution priority over competing limit orders by "stepping ahead" of other orders by an economically insignificant amount.[15] In adopting the Sub-Penny Rule, however, the Commission explicitly declined to prohibit sub-penny trading, including executions occurring at

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functionality, the trade price might not be the actual midpoint at the time of execution, the potential for a trade-through exists and Rule 611 of Regulation NMS is implicated. See 17 CFR 242.611. To address such situations, Liquidnet will be required, when Rule 611 goes into effect on June 29, 2006, to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs of protected quotations.

[14]   See Liquidnet Exemption Request, at 6.

[15]   See Regulation NMS Adopting Release, 70 FR at 37551.

the midpoint of the NBBO, so long as the execution did not result from an impermissible sub-penny order or quotation.[16] The Commission observed that trading in sub-penny increments does not raise the same concerns as quoting in sub-penny increments.[17] Furthermore, midpoint executions can reduce transaction costs by allowing the two parties to a trade to split the difference between the best bid and offer.

On Liquidnet, trades result from a one-to-one negotiation between two subscribers. Subscribers using Liquidnet's midpoint functionality are seeking a midpoint execution irrespective of whether that execution involves sub-pennies. However, the midpoint functionality does not comply with the Sub-Penny Rule in that it displays the midpoint to the two parties, and that midpoint price could be expressed in sub-pennies.[18] While the display of the midpoint price through use of the Liquidnet midpoint functionality could, absent an exemption, constitute a sub-penny quote in violation of the Sub-Penny Rule, the quote would be a limited-purpose byproduct of the midpoint functionality. Due to the way in which Liquidnet operates, the resulting quote should not implicate any issues that caused the Commission to adopt the Sub-Penny Rule and therefore is unlikely to injure the public interest or be contrary to the protection of investors. In particular, because an order negotiated through Liquidnet's midpoint functionality is displayed only to a single other Liquidnet subscriber, it would not cause quote flickering, decreased depth at the inside quotation, or degraded systems capacity, and is unlikely to reduce liquidity. Consequentially, allowing the Liquidnet midpoint functionality to continue to display the automatically-calculated midpoint price on the screen to the other subscriber

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[16]   See id. at 37556.

[17]   See id.

[18]   In a typical midpoint trade by a dealer, the dealer would internalize a customer order at the midpoint of the NBBO, without there being an order or quotation priced in sub-pennies.

participating in the negotiation and allowing Liquidnet to continue to accept orders based on these potential sub-penny quotes provides an incremental benefit to Liquidnet's subscribers without presenting any of the harms attendant to sub-penny quoting in public markets.

This exemption is limited solely to a bid or offer, order, quotation, or indication of interest priced in a sub-penny increment that is automatically generated by use of the Liquidnet system's existing midpoint pricing functionality. This exemption does <u>not</u> extend to any order accepted by Liquidnet the price of which is manually entered by a Liquidnet subscriber. In addition, this exemption is conditioned on Liquidnet continuing to conduct its business, with respect to its midpoint functionality, substantially 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 612(c) under Regulation NMS, that Liquidnet, as of January 31, 2006, shall be exempt from Rule 612(a) of Regulation NMS with respect to any bid or offer, order, or indication of interest entered by a subscriber using the Liquidnet system's midpoint functionality.

By the Commission.

Nancy M. Morris
Secretary