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January 26, 2005

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 this opportunity to comment on the Commission's re-proposed Regulation NMS.

While we embrace the Commission's desire to rationalize the way our equity markets are integrated, we are concerned that some of the provisions of re-proposed Regulation NMS could deprive institutions and the individual investors they represent of hundreds of millions of dollars in trading cost savings that executions in Liquidnet achieved for them during calendar year 2004.

We respectfully refer the Commission to the key points raised in our comment letter submitted on July 2, 2004. In this letter, we briefly update our earlier comments in order not to impose too greatly on the Commission and its Staff.

LIQUIDNET'S AVERAGE EXECUTION SIZE AND COST SAVINGS

- Liquidnet's trading system provides institutional asset managers with an electronic block trading venue. The average execution size for trades in Liquidnet in 2004 was 40,424 shares.[1]

- Liquidnet's average execution size is approximately 116 times greater than the average execution size of INET (the leading ECN), approximately 99 times greater than the average execution size on the New York Stock Exchange, approximately 85 times greater than the average execution size on NASDAQ and

[1] Liquidnet's average execution size since inception is 42,017.

approximately 104 times greater than the average execution size on the Archipelago Exchange (ArcaEx).[2]

- Liquidnet offers institutional investors direct, one-to-one electronic block trading, thereby providing significant savings in the form of reduced commissions, significant price improvement and, perhaps most importantly, reduced market impact costs.

- For 2004, investors achieved average price improvement of 1.6 cents per share across all executions in Liquidnet, resulting in a net execution cost to institutions of 0.4 cents per share.[3] This is extremely low considering the size of the trades executed in Liquidnet, which are often in difficult-to-trade less liquid securities.[4] This low net execution cost does not take into account the additional savings that Liquidnet customers receive through reduced market impact costs.

- In the re-proposed rules, the Commission notes that "the primary component of trading costs for large orders is price impact – the change in stock price caused by the difficulty of executing large orders to buy (with rising prices) or to sell (with declining prices)."

- Based on an analysis by Plexus Group, cited in the release as "a leading authority on the trading costs of institutional investors," the Commission estimates that "the average price impact and search costs incurred across all stocks is a conservative 37.4 basis points."

- Using this estimate, the price impact and search costs for trades executed through Liquidnet during 2004, had they been executed outside Liquidnet, would have been approximately $485,783,204.[5] This amount will continue to increase over time as Liquidnet's trading volume continues to grow.

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[2] Instinet share data available for INET from www.instats.com/toolsresearch June 14 through September 30, 2004. NYSE shares from NYSE Factbook data 2004 through July. NASDAQ shares from Nasdaq newsroom statistics 2004 through November. Archipelago shares from S-1 Registration Statement filed March 2, 2004, representing calendar year 2003.

[3] Liquidnet's 2 cent commission (applicable to all customers) less price improvement of 1.6 cents per share.

[4] The Commission noted as follows in the reproposing release: "The staff analysis also revealed that a large volume of block transactions (10,000 shares or greater) trade through displayed quotations. Block transactions represent approximately 50% of total trade-through volume for both Nasdaq and NYSE stocks."

[5] This result is obtained by multiplying $129,888,557,232 principal value traded through Liquidnet during 2004 by 37.4 basis points (.00374). In its most recent report, Plexus estimated the cost of trading through Liquidnet at 19.46 basis points (weighted average for listed and NASDAQ). Liquidnet believes that the Plexus data significantly overstate the costs of trading through Liquidnet. Because Liquidnet receives indications, rather than orders, from the institution's order management system, the Plexus data count an order as having been transmitted to Liquidnet even in cases where a match has not yet been identified to the parties or the trader is not yet ready to trade the stock. Even assuming Liquidnet's average cost was 19.46 basis points (as calculated by Plexus), this would still provide an estimated cost savings of $233,021,072 for 2004 (in addition to commission cost savings).

- Wayne Wagner, Chairman of Plexus Group, made the following recommendation during testimony before Congress:

  > *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 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 the fourth least expensive broker for NYSE securities and the fourth least expensive broker for NASDAQ securities, respectively, out of 2,000 brokers worldwide.[6] We believe that these rankings are the result of the innovation Liquidnet has brought to institutional trading.

- Liquidnet's cost savings, in the form of reduced commissions, price improvement and reduced market impact costs, are passed through directly to the millions of beneficiaries of the accounts managed by the institutions that participate in Liquidnet.

FAIR ACCESS

- We believe the Commission should clarify that systems that either 1) do not display quotes or orders, or 2) only display orders to one other system subscriber, such as through a negotiation feature, shall not be subject to the ATS fair access requirement.

- The Regulation ATS fair access rule, if applied to Liquidnet, would provide no benefit to investors, and worse, would hinder Liquidnet's institutional customers and, in turn, their shareholders, from achieving the significant cost savings they presently earn.

- As drafted, Regulation NMS would disadvantage Liquidnet vis-à-vis its competitors — block traders and POSIT. These competitors were exempted from the fair access provisions of Regulation ATS when it was adopted, prior to Liquidnet's formation.

- The fair access requirement is aimed at providing access to published quotes; Liquidnet does not publish quotes.[7]

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[6] Elkins/McSherry analysis of Liquidnet's U.S. equity executions for 2003.

[7] The Commission wrote as follows in the original proposing release for Regulation NMS: "In conjunction with the proposed new standards governing intermarket access, the Commission is proposing to lower this

- Since Liquidnet is an electronic block trading desk, it should, like all other block trading desks (such as those managed by traditional sell-side brokerage firms), be exempt from the fair access provisions of Regulation ATS. The regulations should not favor one model of block trading at the expense of another model – adversely affecting institutional investors' ability to seek and obtain the most efficient execution for their block-sized orders.

- If Liquidnet were to put a human trader in the middle of the trading process, thereby making the process less efficient and more costly for the trader, Liquidnet would not be subject to fair access. We believe that the automation of trading results in more efficient and lower-cost trading; accordingly, we disagree with a policy that favors manual trading over electronic trading.

- We agree that the Commission should not mandate admission criteria for a block trading desk. We also agree that the Commission should not mandate admission criteria for ITG's POSIT ATS. Similarly, the Commission should not mandate admission criteria for Liquidnet. We are not aware of any policy basis for distinguishing Liquidnet from block trading desks and POSIT in this regard.

- Innovations that make institutional trading more efficient benefit the institutions and the millions of individual investors whose accounts are managed by those institutions. The Commission should not impose regulations that deter this type of innovation, whether introduced by Liquidnet, POSIT or any other number of existing or future electronic institutional trading systems.

SUB-PENNY PRICING

- Traders using Liquidnet submit priced bids and offers, often at the mid-point. In fact, during 2004, approximately 50% of all Liquidnet executions were at the mid-point of the NBBO. This results in price improvement for both institutions participating in the trade.

- In Liquidnet, if the spread is an odd number (for example, $10.00 - $10.03), a trader who is seeking a mid-point execution will submit 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 believe the SEC should not prohibit 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 40,424-share execution (which is the average execution size in Liquidnet during 2004), price improvement of .5 cents per share would result in

"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."

an average cost savings to each institution of $202 per trade. We believe that, over time, cost savings of this nature are significant.

- Considering how difficult it is for institutions to execute large blocks within the spread (as noted by the Commission in the re-proposing release), the Commission should encourage these types of mid-point executions.[8]

- The Commission should consider whether it is beneficial to have these types of pricing restrictions for sophisticated institutions engaging in private one-to-one negotiations.

TRADE THROUGH RULE

- In our system, a trader can 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 that could move 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 unnecessarily and detrimentally frustrate institutional traders from achieving the best execution for their ultimate customers. Accordingly, we believe that, for a one-to-one negotiation system, the system should 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 at 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 of 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."

BLOCK TRADING EXEMPTIONS

- Liquidnet requests that any exemptions granted by the Commission to block traders under Regulation NMS be extended to electronic block trading systems like Liquidnet.

CONCLUSION

We would again like to thank the Commission for the opportunity to present our views.

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[8] See footnote 4 above.

Liquidnet is an experiment that has proven its value, as evidenced by our nearly four-year track record, our continually growing customer base, and 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. The Commission should consider carefully before adopting rules that could stifle cost-reducing innovations in electronic trading.

Very truly yours,

Seth Merrin
Chief Executive Officer