TESTIMONY ON REGULATION NMS BEFORE THE SECURITIES AND EXCHANGE COMMISSION

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Location:	**[New York, NY] [Washington, DC]**
Presenter:	**Seth Merrin on behalf of Liquidnet, Inc.**

INTRODUCTION

Good [morning] [afternoon]. My name is Seth Merrin. I am the CEO of Liquidnet, Inc. Liquidnet operates an electronic block trading system. We are registered as a broker/dealer and as an alternative trading system.

I am here today to express Liquidnet's views on the Regulation NMS proposals as they relate to institutional trading.

Before I proceed with the main part of my speech, I would like to thank the Securities and Exchange Commission for affording Liquidnet and other members of the industry the opportunity to present our views before the Commission. We applaud the Commission's efforts in putting forth the proposals in Regulation NMS, and we support many of the proposals. The concerns we express today relate to specific provisions of the proposed regulation and not to the regulation as a whole. In particular, we are concerned that some specific proposals will have an adverse effect on existing and future efficiencies in the institutional trading market.

BACKGROUND ON LIQUIDNET

I founded Liquidnet in November 1999 with a specific purpose in mind – to make institutional 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 – and we have held firm to our purpose.

Liquidnet commenced trading of U.S. securities in April 2001. We commenced trading in five European markets in November 2002. Since inception, our average execution size for U.S. securities has been more than 43,500 shares, which is nearly 90 times the average execution size on the New York Stock Exchange.[1] 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, shows that institutions do not have to sacrifice size for price.

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[1] Liquidnet average execution size from inception through March 23, 2004; NYSE average execution size of 488 shares for 2003 (NYSE Fact Book – www.nysedata.com).

Liquidnet is an execution-only trading venue. We do not do investment banking, and therefore cannot get our customers into IPOs. We do not have a research business. We do not sell our customers' mutual funds. This means an institution would use Liquidnet only if it determined that we provided an efficient execution of their block orders.

Our success to date shows that, at least as far as many institutions are concerned, we provide an efficient execution of their block orders. To date, Liquidnet has 198 live institutional customers and an additional 48 firms waiting to go live. This customer base collectively manages $6.15 trillion in equity assets.[2] In less than three years, these firms have executed more than 6 billion shares through Liquidnet at a value of nearly $300 billion.[3] In its most recent report, Plexus Group ranked Liquidnet as the 19th largest Listed broker and 26th largest NASDAQ broker out of its universe of 1,500 institutional brokers[4].

Through software that we provide to our institutional customers, buy-side firms are able to enter into anonymous one-to-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.[5]

THE PROBLEM OF INSTITUTIONAL TRADING COSTS; LIQUIDNET'S SOLUTION

As the Commission has pointed out in the Reg NMS release, market impact costs are a significant issue for institutional investors.[6]

Traditional markets are efficient in handling small and medium-sized orders but are not well adapted for handling institutional block-sized orders. In fact, more than 98% of trades that take place on the NYSE are for less than 10,000 shares.[7] In addition, a typical institutional order of 100,000 shares[8] is more than 200 times the average 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. It's the equivalent of dropping a boulder into a pond.

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[2] Big Dough analysis based on Q4-2003 data.
[3] Liquidnet Membership data as of March 24, 2004.
[4] Plexus Group report covering Q4 2002 to Q3 2003.
[5] US Department of Labor, Pension and Welfare Benefits Administration; *The Wall Street Journal* (May 2, 2003).
[6] SEC Release No. 34-40325, Regulation NMS, February 26, 2004, p. 14.
[7] NYSE Fact Book – www.nysedata.com.
[8] 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 and profit from the information at the expense of that institution. Because of that process, institutions hold their order information very close to the vest and will 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.[9]

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.

I also want to mention another firm that advises buy-side institutions on trading costs – Elkins/McSherry. 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.[10] 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.

INCENTIVIZING LIMIT ORDERS

We understand that one of the goals of Reg NMS is to encourage institutions and other market participants to place and execute limit orders in the market. While we agree that this is an important goal, this alone will not solve the market impact cost issues that institutions face when executing block trades.

An institution has three basic tools for executing block orders. Each of these tools has advantages, and each has drawbacks, but to best serve its funds, the institution needs all three tools.

[9] 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.

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

The first tool is the traditional block-trading desk. 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 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 second tool available to the institution is direct access to the ECNs and other electronic order books. For simplicity, I will just refer to ECNs. An ECN preserves anonymity and can provide fast executions, but it is typically better suited for executing small to mid-size orders. For example, the average execution sizes on Instinet and Archipelago during 2003 were 472 and 389 shares, respectively.[11] Using these trading venues, 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 I am an institutional trader with a limit order to buy 500,000 shares of a security. The market is showing a total of 5,000 shares to sell across offers within my limit. If I were to execute against these 10 offers, I would still be looking to buy 495,000 shares. In the meantime, I've sent a clear signal to the market that there is a buyer out there, which will move the market against me. In addition, the market may have moved away from my limit price during the time it took me to execute these first 10 trades. Now the bulk of my order – some 495,000 shares – will not enter the market.

Clearly, the ECNs are much more geared toward retail-sized executions. This is in contrast to Liquidnet, which as I previously mentioned, has an average execution size of 43,500 shares.

A third tool available to the institutions are crossing or continuous negotiation systems, like POSIT or Liquidnet. I will 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.

To achieve best execution for his or her accounts, the buy-side trader must have all three tools available. That is why we are concerned about the Commission's proposal on fair access.

[11] Sandler O' Neill & Partners, LLP research.

FAIR ACCESS PROPOSAL

In Reg NMS, the Commission proposes to revise Reg ATS and 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 threshold for all securities. To our knowledge, the Commission has provided only limited guidance as to what constitutes fair access.

We propose that the fair access threshold remain at 20% for all systems. We believe that the issues the SEC is attempting to address regarding access are already addressed through the SEC access proposals in Reg NMS.

Alternatively, we recommend that the fair access threshold be eliminated for systems that either do not display orders – such as POSIT – or that display orders only to one other participant through a one-to-one negotiation – such as Liquidnet.

If neither of these proposals is acceptable, at a minimum the Commission should allow a 20% threshold to remain for these types of crossing systems. This distinction was made in the Reg ATS releases in relation to the ATS order display requirements.[12]

A system like Liquidnet is much more similar to a block-trading desk attempting to cross two customer orders than it is to an ECN. 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 automation to make the block-trading process more efficient.

If we look at Liquidnet relative to block trading desks, there are various reasons why Liquidnet might present fewer potential concerns to a regulator when compared with a traditional block-trading desk. Liquidnet does not do investment banking. Liquidnet does not have a research department. Liquidnet does not sell our clients' mutual funds. We also do not trade as principal, so we do not trade against our clients. All of these areas of potential conflict are simply not present in Liquidnet. In addition, Liquidnet provides a full audit trail of every trading event, including indications, orders, negotiations and executions. Liquidnet also executes 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.

[12] See, for example, the Regulation ATS adopting release: "Finally, alternative trading systems are not required to provide to the public quote stream orders displayed to only one other alternative trading system subscriber, such as through use of a negotiation feature." Release 34-40760.

We are concerned that the meaning of fair access is not clearly defined. Liquidnet has been successful because of the safeguards the system provides for the institution's information, and because we restrict participation in Liquidnet to those institutions that invest for the longer term, which again is on behalf of the mutual fund and pension fund holders. If we were required to open our system to those who do not have the ability or the intention to execute block-size orders, it would compromise the confidentiality of our customer information and work against the benefits that the system provides.

One final point on this issue. Liquidnet and POSIT are only two crossing systems. Other crossing systems exist today or may arise in the future – I can guarantee that they will arise. 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. And, as I mentioned previously, such efficiencies ultimately benefit the individual investor whose account is managed by those institutions. Let's not impose regulations that deter this type of innovation.

SUB-PENNY PRICING AND OPT OUT

We would also like briefly to express our views on two other proposals in Reg NMS: sub-penny pricing and the opt-out provision for the trade through regulation.

We agree that sub-penny pricing has led to abuses in this industry, and therefore should be eliminated. However, we recommend an exception for orders that are pegged to the mid-price either at the time the order is received or at the time the order is executed. In these cases, two traders are looking to split the spread and gain price improvement for both sides. They should not be penalized simply because that mid-point is in sub-pennies. Mid-point trading should be encouraged, and we would contend that the majority of institutional traders prefer a mid-point execution. In fact, POSIT's business model is predicated on this. In Liquidnet alone, 48% of all our executions occur at the mid. The result is an average price improvement of 1.9 cents per share for each side for trades executed in Liquidnet, meaning that our customers earn back an average of 95% of their commission costs per trade.[13]

We believe that the Commission should carefully consider the relative costs and benefits of applying trade-by-trade opt out to institutional investors. Liquidnet views institutions as sophisticated investors who actively trade in multiple venues and who actively manage their orders. As such, we firmly believe that a global opt out provision for institutions is warranted and necessary.

The opt out is really designed for retail investors. The institutional trader understands the issue of market impact cost and the trade-off between speed and certainty of execution versus executing within the spread. It is the job of the institutional trader to make these kinds of determinations, and the institutional trader is in that position because he knows how to make these determinations. The institutional trader also has much more control over an order's execution than does a retail investor.

[13] Liquidnet charges a uniform commission of 2 cents per share to all subscribers.

A trade-by-trade opt out not only would provide no value to the institutional trader, it would also make it more difficult for the trader to do his job. A buy-side trading desk can be a hectic place – traders often have multiple orders to keep track of; they deal with multiple brokers and trading venues. In addition, the traders are dealing with large share and dollar amounts, and they are expected to get things done promptly. It makes no sense to add the additional burden of a trade-by-trade opt out on the trader in this type of environment, particularly where the burden would provide no benefit to the trader or the institution.

CONCLUSION

To conclude my remarks, I would like to once again 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 was 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 this 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.

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