

October 18, 2011

By e-mail

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 2006-1506
pubcom@finra.org

Re: Proposed Amendments to Rule 5210 Regarding Publication of Indications of Interest

Ladies and Gentlemen,

Liquidnet, Inc. (Liquidnet) appreciates the opportunity to submit this comment letter on the proposed amendments by the Financial Industry Regulatory Authority (FINRA) to FINRA Rule 5210. The proposed amendments are described in FINRA's Regulatory Notice 11-43 (the Regulatory Notice).¹ Liquidnet supports the efforts of FINRA to ensure that information communicated by broker-dealers regarding indications of interest (IOIs) is accurate and not misleading and that the interests of customers are protected.

In support of this objective, Liquidnet proposes that FINRA amend clause (d) of the proposed Supplementary Material to Rule 5210 to provide that it would be permissible for a broker-dealer to display an IOI as a customer IOI if the following three conditions have been met:

- the broker-dealer has received from the customer either an order or a bona fide indication of interest in the security;
- the customer has consented to the communication of an IOI by the broker-dealer to third-parties; and
- the scope of such communication to third-parties is consistent with the scope of the consent provided by the customer.

As discussed in more detail below, our proposal has two primary objectives:

¹ Financial Industry Regulatory Authority, Regulatory Notice 11-43, "FINRA Requests Comment on Proposed Amendments to Rule 5210 Regarding Publication of Indications of Interest," <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p124474.pdf> (accessed October 18, 2011).

- ensure that institutional traders preserve the ability to negotiate block trades directly with other institutional traders; and
- ensure that any communication of an IOI on behalf of a customer is conditioned on the customer's prior consent.

In this letter we provide a brief background on Liquidnet and our negotiation system. We then discuss our proposed modification and respond to the specific questions posed by FINRA in the Regulatory Notice.

Background on Liquidnet and our negotiation system

Liquidnet is a broker-dealer registered with the Securities and Exchange Commission and a member of FINRA. We operate two SEC-registered alternative trading systems (ATs) – the Liquidnet Negotiation ATs; and the Liquidnet H2O ATs. Our comments relate specifically to our negotiation system.

Liquidnet is an agency-only firm. Our customers are primarily the buy-side investment management firms that operate mutual funds and other managed accounts and trade on behalf of tens of millions of U.S. citizens. As long-term investors, our customers are the most important source of investment capital for public companies in the U.S.

Liquidnet receives indications of interest from our institutional customers. When we receive matching buy and sell indications from two institutions, we display a notification to both sides. The buying and selling institution then have the opportunity to negotiate and execute a trade directly with each other through our system.

Liquidnet's average negotiated execution is 48,909 shares.² This is 195 times larger than the average execution size on NYSE Euronext (251 shares)³ and 231 times larger than the average execution size on NASDAQ (212 shares).⁴

The primary benefit for institutions in using Liquidnet is their ability to execute large block trades with reduced market impact. In its ranking of execution quality for institutional trading for 2010, *Pension & Investments* ranked Liquidnet #1 in execution quality across all institutional brokers.⁵ For 2010, *Pension*

² Liquidnet trading data, August 2011.

³ http://www.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=3133&category=3 (August 2011) (accessed October 18, 2011).

⁴ <http://www.nasdaqtrader.com/Trader.aspx?id=MonthlyMarketSummary> (August 2011) (accessed October 18, 2011).

⁵ "Tradewatch," *Pensions & Investments*, March 7, 2011, <http://www.pionline.com/article/20110307/CHART1/110309936> (accessed October 18, 2011).

& Investments commissioned Elkins/McSherry to conduct the study of institutional trading costs. Elkins/McSherry is a firm that has studied institutional trading costs for many years.⁶

Pension & Investments also ranked Liquidnet #1 in execution quality for 2009.⁷ For 2009, *Pension & Investments* commissioned BrokerEdge™ to conduct this study. BrokerEdge™ further ranked Liquidnet #1 in execution quality for 2008 across all global brokers.⁸ Like Elkins/McSherry, BrokerEdge™ is a firm that has studied institutional trading costs for many years.

Elkins/McSherry and BrokerEdge™ have both ranked Liquidnet #1 in execution quality for institutional orders. While there are different approaches for evaluating institutional trading costs, it is significant when one broker is ranked #1 for three consecutive years according to two distinct industry-leading methodologies.

In addition to reduced market impact cost, Liquidnet also provides a level of price improvement well above the industry average. Over 90% of the negotiations in Liquidnet are executed at the mid-point of the NBBO, providing 100% price improvement to both sides to the trade. According to Rule 605 data, for 2011 (through September) Liquidnet has provided average price improvement to customers of 94.08% as compared to the industry average of 4.64%.⁹ For this nine-month period, Liquidnet has provided 20 times more price improvement than the industry average.

Proposed amendment

Liquidnet proposes that FINRA amend clause (d) of the proposed Supplementary Material to Rule 5210 to provide that it would be permissible for a broker-dealer to display an IOI as a customer IOI if the following three conditions have been met:

- the broker-dealer has received from the customer either an order or a bona fide indication of interest in the security;
- the customer has consented to the communication of an IOI by the broker-dealer to third-parties; and
- the scope of such communication to third-parties is consistent with the scope of the consent provided by the customer.

⁶ *Pension & Investments* published the results in its "Tradewatch" publication.

⁷ "Tradewatch," *Pensions & Investments*, March 8, 2010, <http://www.pionline.com/apps/pbcs.dll/article?AID=/20100308/CHART/100309924&crit=liquidnet&template=printart> (accessed October 18, 2011).

⁸ Investment Technology Group "ITG Broker Edge™ Core Broker Report" for U.S. trades for the four quarters ended December 31, 2008, cited in April 30, 2009 press release, "Liquidnet Ranked #1 in 62% of all Execution Categories According to ITG Broker Edge™ Core Broker Report."

⁹ Rule 605 data compiled by Thomson Transaction Analytics Reports, January to September 2011.

Our proposal has two primary objectives:

- ensure that institutional traders preserve the ability to negotiate block trades directly with other institutional traders; and
- ensure that any communication of an IOI on behalf of a customer is conditioned on the customer's prior consent.

Under clause (d) as proposed by FINRA, a broker-dealer only can display an indication of interest on behalf of a customer if it has received an order from the customer; clause (d) does not appear to cover the situation where the broker-dealer has received a bona fide indication from the customer. However, in our system, Liquidnet displays bona fide indications of interest on behalf of a customer to other institutional customers with bona fide contra-side indications of interest in the same stock. The institutional traders then negotiate directly with each other based on their matching IOIs.

Because clause (d) is limited to the situation where the broker-dealer has received a firm order from the customer, it would effectively prohibit institutions from negotiating block trades directly with each other, whether through Liquidnet or another trading venue. The intermediary broker (in this case, Liquidnet) could not display the matching IOIs to each side that form the basis for the negotiation because the buying and selling customers have not yet created firm orders. While institutions using Liquidnet negotiate directly with each other, as a technical matter Liquidnet acts as an intermediary to facilitate booking and settlement of the trade and to allow institutional customers to preserve their anonymity when trading with each other. In other words, even though the customers negotiate directly with each other, an intermediary agency broker is technically the party that communicates the IOIs on behalf of the buying institution to the selling institution and on behalf of the selling institution to the buying institution.

Clause (d) as drafted could prevent institutions from using systems like Liquidnet that help them reduce their trading costs by negotiating directly with each other. We do not believe this is FINRA's intention because FINRA's proposed clause (c) contemplates a broker-dealer communicating a bona fide indication on behalf of a customer.

Liquidnet retrieves IOIs from the order management systems (OMSs) of our customers. The OMS is software used by the institution to manage its orders. Interfacing with the customer's OMS is a control that helps validate that the IOI is bona fide.

While the IOI received from the customer is bona fide, it is not the same as a firm order. The IOI could best be understood as an intention from the customer to trade, but one that is conditional upon events

in the market. An institutional trader could take into account a number of factors in determining whether to proceed to negotiate on an IOI, including: price movement in the stock, industry sector or market; news events impacting the issuer, the issuer's industry sector, the issuer's competition or the overall market; volatility in the stock or the market; trading activity in the stock; and subsequent instructions from the institution's portfolio manager who initially instructed the institutional trader to buy or sell the particular stock.

Liquidnet has adopted and communicated customer usage protocols to monitor that customers take positive action on a specified percentage of IOI's. This helps to ensure that customer IOIs are bona fide. However, institutional customers cannot always commit to convert their IOIs to firm orders, and it is important that institutional traders retain the flexibility to negotiate directly with each other on their matching IOIs. A literal reading of proposed clause (d) could prevent this type of activity, which we do not believe to be FINRA's intent because clause (c) contemplates the communication of bona fide indications of interest on behalf of customers.

Under our proposed modification, any communication of an IOI is subject to the customer's prior consent. This is an essential condition because disclosure of an IOI without the customer's consent could result in information leakage of the institution's block order.

Specific requests for comment

In Regulatory Notice 11-43, FINRA solicits comments on a series of specific issues relating to its IOI proposal. We provide our views on each of these issues.

Defining the term "indication of interest"

We would define an IOI as a bona fide but non-binding expression of interest to buy or sell a security. An IOI is non-binding in that a further affirmative action is required by the trader before a trade can be executed.

We believe that FINRA Rule 5210(c) accurately defines the term IOI through its description of an IOI as "a bona fide interest in purchasing or selling" a security. This description is consistent with our understanding of the term IOI as discussed in the preceding paragraph. While we do not believe that any further definition of the term IOI is required, we would not object to FINRA making this definition more explicit.

Does FINRA's proposal adequately address the issue of inaccurate labeling?

Subject to the changes we have proposed, we believe that FINRA's proposal adequately addresses the issue of inaccurate labeling.

Should the term “natural” be defined?

In the proposed rule FINRA uses the terms “member” and “customer.” We believe these are the appropriate terms to use. “Members” refer to broker-dealers, such as Liquidnet. “Customers” refer to institutional customers of FINRA member firms, and also can include broker-dealer customers of a FINRA member firm.

The term “natural” is sometimes used to describe an institutional investor that has an indication or order on the opposite side of another institution’s indication or order. Since a “natural” would be a type of customer, we believe the rule satisfactorily addresses this point as currently drafted.

Is the current requirement too limiting? Is there an alternative standard that could achieve the same regulatory purpose?

We believe the current requirement is too limiting in that an institutional customer should have the ability to communicate an IOI to another institutional customer through a trading venue like Liquidnet, even when the institutional customer does not have a firm order, as long as the institution has a bona fide intention to trade the security.

We also believe that FINRA can help ensure further protection for customers by providing that a broker-dealer can only communicate a customer IOI to a third-party when the customer has consented to the communication of the IOI by the broker-dealer to third-parties and the scope of such communication to third-parties is in accordance with the scope of the consent provided by the customer.

Buy-side firms concern regarding information leakage

Buy-side firms have a legitimate concern regarding information leakage. This is particularly important when you consider that the average institutional order is 188,401 shares,¹⁰ which is 751 times larger than the average execution size on NYSE Euronext. If an institution’s intention to buy 188,000 shares of a stock is communicated to the market without the institution’s consent, high-frequency traders and other short-term traders in the market can purchase shares ahead of the institution, with the confidence that they can sell back to the institution at a higher price. In the end, this higher price paid by the institution (often referred to as “market impact cost”) is passed on the tens of millions of individual long-term investors who invest through mutual funds and similar investment vehicles.

Because of the risk of information leakage, it is very important that a broker-dealer not transmit an IOI on behalf of an institutional customer without the institutional customer’s consent. Ultimately, it should be the decision of the buy-side trader regarding how to disseminate information regarding its block orders.

¹⁰ Liquidnet data, August 2011.

Conclusion

We appreciate the opportunity to submit this comment letter on FINRA's proposed amendments to Rule 5210. Please contact me at (646) 674-2044 or by e-mail (hmeyerson@liquidnet.com) if you have any questions or comments regarding our proposals.

Very truly yours,



Howard Meyerson,
General Counsel, Liquidnet, Inc.