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Ontario Securities Commission
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By Overnight Courier

October 19, 2005

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Re: Liquidnet Canada Inc. – Comment Letter on CSA Discussion Paper 23-403, Market Structure Developments and Trade-Through Obligations

Ladies and Gentlemen:

Liquidnet Canada appreciates the opportunity to submit this comment letter on CSA Discussion Paper 23-403, Market Structure Developments and Trade-Through Obligations (the "Discussion Paper").

I. BACKGROUND ON LIQUIDNET

Liquidnet Canada Inc. operates the Liquidnet trading system for Canadian subscribers. Liquidnet Canada is a wholly-owned subsidiary of Liquidnet Holdings, Inc. Liquidnet Holdings, Inc. has two other wholly-owned subsidiaries – Liquidnet, Inc., which operates the Liquidnet trading system for US subscribers; and Liquidnet Europe Limited, which operates the Liquidnet trading system for European subscribers. Liquidnet Europe now makes trading available in the securities of 13 European jurisdictions.

Liquidnet Canada is registered as an investment dealer with the Ontario Securities Commission and the Autorité des Marchés Financiers. Liquidnet Canada also is a member of the Investment Dealers Association of Canada. Liquidnet Canada's market activities are regulated by Market Regulation Services Inc. ("RS"). The Liquidnet trading system is registered with the Ontario Securities Commission and the Autorité des Marchés Financiers as an alternative trading system.

The Liquidnet trading system is an electronic block trading system. Liquidnet was founded in November 1999 for a specific purpose: to use technology to reduce the costs -- both explicit and implicit -- incurred by institutions in executing block trades.

Using Liquidnet, buy-side institutions enter into anonymous one-on-one negotiations for the purchase and sale of large blocks of equity securities. In doing so, these institutions avoid the market impact costs associated with using traditional market intermediaries (including traditional block execution brokerage firms) to execute block trades. These substantial cost savings – see Section II below -- 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.

Since Liquidnet's inception, the average execution size for U.S. equity securities traded on Liquidnet has been 41,299 shares.[1] In comparison with some of the traditional public markets in the US, Liquidnet's average execution size is approximately:

- 87 times the average execution size on Nasdaq;
- 105 times the average execution size on the New York Stock Exchange (the "NYSE");
- 106 times the average execution size on Archipelago; and
- 118 times the average execution size on Instinet ECN.[2]

Liquidnet combines this industry-leading average execution size with significant cost savings through reduced market impact costs, lower commission rates relative to traditional block traders, and average price improvement of 1.6 cents (US) per share.[3]

We further note that since inception approximately 93% of Liquidnet's executions have been within the spread. We note that for the 7% of trades executed outside the spread, in a significant majority of cases a Liquidnet customer submitted a bid or offer during a negotiation that was within the spread at the time of the customer's bid or offer but "put offside" by an order displayed in another marketplace between the time the Liquidnet customer submitted the bid or offer and the time the contra-party in the Liquidnet negotiation accepted the first customer's bid or offer.

Liquidnet's sole business is to provide agency executions through the Liquidnet system. To that end, Liquidnet does not engage in investment banking or provide its customers with shares in IPOs. Liquidnet does not conduct a research business or sell its customers' mutual funds. An institution uses Liquidnet only if it determines that Liquidnet provides efficient execution of the institution's block orders. Accordingly, Liquidnet's success to date is based entirely on its ability to execute its customers' block orders with significant cost savings.

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1 Through September 30, 2005.

2 Liquidnet average execution size from inception through September 30, 2005. *See* NYSE data - 2004, www.nysedata.com/factbook; Nasdaq data - January – November 2004, www.nasdaq.com/newsroom.ststs; INET data - June 14 – September 2004, www.instats.com/toolsresearch; Archipelago data - January - June 2004, Archipelago Holdings, L.L.C. Form S-1, dated March 2, 2004, as amended.

3 Price improvement is for 2004.

Until recently, trading by Liquidnet subscribers in Canada has been limited to US securities that are not inter-listed in Canada. Effective as of September 17, 2005, Liquidnet has expanded trading in US securities to include inter-listed securities. Liquidnet also plans during 2006 to commence trading in Canadian securities, subject to our ability to comply with applicable regulatory requirements.

II. How Liquidnet Reduces Institutional Trading Costs

Liquidnet provides three specific types of cost savings to its institutional customers: lower commissions, price improvement, and reduced market impact costs. These cost savings represent reductions to institutional investors' explicit costs as well as to their implicit costs.

A. Explicit Costs

Liquidnet charges a commission of 2 cents per share.[4] This commission rate is low relative to the commission charged by traditional block trading firms to institutional investors, which one authority has estimated as 3.7 cents per share.[5] Based on Liquidnet's 2004 trading volume in U.S. securities of approximately 5.09 billion shares, this 1.7 cents savings per share works out to an aggregate savings of approximately $86.5 million for Liquidnet's customers during 2004.

In addition to reduced commissions, as noted above, Liquidnet's customers realize an average of 1.6 cents per share in price improvement on each trade executed through Liquidnet.[6] This price improvement results in a net average execution cost of 0.4 cents per share (Liquidnet's 2 cent commission less 1.6 cent average price improvement), which is extremely low considering Liquidnet's average execution size of more than 41,000 shares per trade. Based on Liquidnet's 2004 trading volume, this price improvement works out to additional savings of approximately $81.4 million for Liquidnet's customers during 2004.

We anticipate that the total amount of explicit savings that Liquidnet provides for investors will increase year-to-year as Liquidnet's trading volume continues to grow.

B. Implicit Costs

Commissions, net of price improvement, account for the explicit cost of institutional trading. However, institutional trading also has an implicit cost in the form of price impact. The US Securities and Exchange Commission has stated in the re-proposing release for Regulation NMS 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)."[7]

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4 Monetary amounts referred to in this letter are in US currency. The discussion in this section relates to the US equity market, Liquidnet's primary trading market.

5 Based on estimates for 2004 by the Plexus Group.

6 Based on Liquidnet executions during 2004.

7 Securities Exchange Act Release No. 50870, Regulation NMS (December 16, 2004), 69 FR 77424 ("Re-Proposing Release") at 77425.

Traditional public markets, including the TSX, LSE, NYSE, Nasdaq and ECNs, are efficient in handling small and medium-sized orders but are not well adapted to handle institutional block-sized orders. If an institutional investor were to transmit an order for 250,000 shares directly to a traditional public market, the order would significantly increase demand for the security and move the price of the security against the institution that placed the order.

Institutions know that the simple knowledge of who they are or the size of their orders will trigger market intermediaries and other market participants to take advantage of and profit from that information at the expense of the institution. As a result, institutions hold their order information very closely and generally do not expose it to the public markets. Liquidnet uses technology to provide institutions with a quantity discovery mechanism while safeguarding institutions' order information from the market participants who would use that information to profit at the expense of the institutions' returns to their individual investors.

While implicit costs vary by portfolio, we believe the savings enjoyed by Liquidnet's customers are largest in this area, and thus reduction of the implicit costs are a key contributor to the rapid adoption of Liquidnet by institutional investors worldwide.

III. LIQUIDNET'S COMMENTS ON THE CSA DISCUSSION PAPER

Liquidnet appreciates the opportunity to comment on the CSA Discussion Paper. In this section we will provide our views on trade-through in general and as applied to the Liquidnet system. We will then respond to specific questions presented in the CSA Discussion Paper.

A. Trade-through rule

As indicated above, we operate the Liquidnet system in multiple jurisdictions. For trading in UK securities, we are subject to the London Stock Exchange's trade-through rule (see more detailed discussion below). In the US, as you are aware, a trade-through rule will be implemented in June 2006. We participated in the public debate on trade-through and we are at present participating in the Securities Industry Association's Working Group on operational issues relating to implementation of trade-through in the US.

We have considered the arguments for and against the trade-through rule. We understand the arguments in favor of the trade-through rule, specifically that a trade-through rule, by protecting limit orders, encourages the placement of limit orders, resulting in greater liquidity within the market. We also understand the arguments against the trade-through rule, specifically that it might be advantageous in certain circumstances for an investor to trade outside the spread. This is particularly relevant for institutions seeking to trade large blocks, where an execution 1 or 2 cents outside the spread might be preferable to the potential market impact cost that could result from delaying the execution.

On the whole, we believe that a trade-through rule is not necessary, particularly for institutional orders. That being said, if a trade-through rule is adopted by the Canadian regulators, we are fully-prepared to comply with such a rule.

If a trade-through rule were adopted, we would propose the following application in the case of a one-to-one negotiation system, like Liquidnet. In our system, a customer can submit a bid or offer to another customer during a negotiation that is within the spread at the time of the bid or offer but could be "put offside" by an order subsequently booked in another marketplace in the seconds it takes for the bid or offer by the first Liquidnet customer to be accepted by the second Liquidnet customer. 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 investors. Accordingly, we believe that, for a one-to-one negotiation system, the system should only need to 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. We note that in this situation, the institution's intention at the time of order submission is clearly to trade within the spread.

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."[8]

B. Operational considerations

Assuming that a trade-through rule is adopted, operational considerations must be taken into account. Specifically, we do not believe that a trade-through rule would be feasible until a consolidated quote were generally available. At present, equity trading in Canada is almost exclusively on the Toronto Stock Exchange. However, Markets Inc. recently commenced trading in Canadian securities, CNQ has announced plans to competitively-quote TSX-listed securities and, with continuing advances in technology, it is likely that other equity trading venues will arise in the future. If there is no consolidated quote, every venue would need to link with every other venue. We do not believe that this is an efficient solution. We believe that a trade-through rule would only be appropriate where a consolidated quote – either provided by the regulators or a private market data provider – were available.

C. Trading in inter-listed securities

One issue presented by the CSA Discussion Paper is whether, for trading by Canadian investors in inter-listed securities outside Canada, it is sufficient to comply with the trade-through rule of the jurisdiction where the securities are being traded (the "foreign jurisdiction"); or whether there must also be consideration given to the best bid and offer in the Canadian markets. If it were also a requirement to look to the best bid and offer in the Canadian markets, this would in effect apply a second trade-through restriction on a single order. We strongly oppose the application of a second trade-through restriction in this situation.[9]

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[8] Please note that the UK Financial Services Authority has not adopted a trade-through rule. Accordingly, the applicable trade through rule for the UK is the LSE's trade-through rule.

Liquidnet currently trades in the securities of 14 jurisdictions (excluding Canada), and none of these jurisdictions has any requirement that would mandate trading to occur within the best bid and offer of the investor's jurisdiction when the investor trades in another jurisdiction. In fact, we are not aware of any jurisdiction with this type of rule.

We can consider an example where a Canadian subscriber to Liquidnet determines that it wants to trade an inter-listed security in US dollars. As of today, there is no trade-through restriction applicable to that order. However, commencing on the implementation date for the trade-through rule in the US, which is currently scheduled for August 2006, a trade-through restriction would apply. In this situation, the Canadian subscriber would be subject to the US trade-through restriction. We believe there is little advantage in also requiring the trade to be within the Canadian CBBO as the US and Canadian markets will in almost all cases be very close in price. This is because of arbitrageurs who will quickly seek to take advantage of any arbitrage between the Canadian and US prices of the same issuer's securities.

While there is minimal advantage in applying a second trade-through test for this order, there are significant reasons not to do so:

- First, mandating a second validation for trade-through between the time a price is agreed to by the trading parties and the time of execution requires additional computer processing, potentially resulting in delayed executions, failed executions and regulatory concerns for the market where the security is traded (referred to as the "foreign market"). If a market performs the validation for the foreign market before performing the validation (including a currency conversion computation) for the Canadian market, the first trade-through validation is now further in time from the time of execution. Because there must be some time lag between the time of a trade-through validation and time of execution (the two steps cannot be simultaneous), no market can guarantee it will execute within the CBBO determined at the exact time of execution. However, the market must reduce the number of computations required between the time of trade-through validation and execution, so at to minimize the percentage of trades that are executed outside the CBBO of the foreign market. Adding a requirement for a second trade-through validation could be a concern for the regulators in the foreign market because, if the CBBO for the foreign market is validated first, it is now more likely that the execution price will be outside the CBBO at the actual time of execution. Alternatively, a market could perform the validation for the foreign market second, but this would make the validation for the foreign market further in time from the time the price was agreed to by the parties, resulting in an increased percentage of failed executions.
- Second, if we consider an inter-listed security where the significant majority of the liquidity is traded in the US markets, such a rule could effectively prevent Canadian institutions from accessing the US-market liquidity in those securities if, as is likely, the US market does not implement a process to validate for the CBBO in Canada. This would

[9] In this context, we are, however, supportive of a requirement that the foreign market be properly open, with a properly-established and reasonable bid-ask quote, if the CSA determines such a requirement would be helpful in preventing abuses.

be to the detriment of pensioners and other accounts on whose behalf Canadian institutions trade.

- Third, there would be points in time when certain inter-listed stocks could not be traded in the foreign market because the foreign and Canadian markets are crossed.
- Fourth, specifically with respect to our system, if a Canadian investor is negotiating a trade with a foreign investor, we are concerned that if an execution does not occur because of a trade-through restriction that is unrelated to the jurisdiction where the security is traded, this will cause unnecessary frustration to the foreign investor.
- Fifth, from the stand-point of RS, there could be significant cost in monitoring activity that occurs on markets worldwide, particularly in relation to the limited potential benefits in applying such a restriction.

D. On whom should the trade-through rule obligation be imposed?

We believe that the only feasible approach is to impose the trade-through rule obligation on the market (exchange or ATS) or dealer that is actually executing the trade. The validation for trade-through must be performed immediately prior to execution. The only party in a position to perform this validation reliably is the market or executing dealer. A routing broker or a customer could perform this validation when it sends the order to a market or executing dealer, but if the execution occurs one minute after the order has been routed or transmitted, the validation performed by the routing broker or customer is no longer reliable.[10]

In addition, imposing the trade-through obligation on the routing broker or customer would require each of them to obtain a consolidated market data feed. We believe this would impose unnecessary cost.

E. Undisplayed orders

We believe that trade-through protection should be limited to displayed orders. We do not believe it is feasible to provide protection for an undisplayed order, which, by definition, will not be included in the displayed CBBO. Since we do not trade for our own account, our only option for complying with trade-through is to reject any customer order that is outside the displayed CBBO (we are not in a position to satisfy better-priced orders). Accordingly, we need to be able to determine immediately prior to execution whether or not our customer's order is within the CBBO. We cannot make this determination with respect to undisplayed orders.

IV. CONCLUSION

We would like to thank the Canadian Securities Administrators for the opportunity to comment on the CSA Discussion Paper. As discussed above, the Liquidnet system has provided significant cost savings in the US and Europe to institutions and the beneficiaries of the accounts on whose behalf they trade. Our goal in the future is to provide these cost savings to institutions in Canada and their beneficiaries.

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[10] We are not suggesting that the market or executing dealer should have an obligation to route to the best posted price. We believe it is the function of the routing broker to achieve best execution for the customer by locating and routing to the best posted price. It should then be the function of the market or executing dealer to validate for compliance with any applicable trade-through rule obligation.

In adopting and implementing regulations, we are confident that the CSA will focus on what is ultimately in the best interests of all investors - retail investors as well as pension fund beneficiaries and other individuals on whose behalf institutional investors trade. We believe it is important for regulators to adopt regulations that promote competition, innovation and the introduction of new technologies, as we believe these types of regulations accrue to the benefit of all investors.

Very truly yours,

Eric LeGoff, President