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NYSE PROPOSED RULE CHANGE RELATING TO AMENDMENTS TO "HYBRID" PROPOSAL

[18190] November 12, 2004 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 44-04 SEC RULES COMMITTEE No. 89-04 RE: NYSE PROPOSED RULE CHANGE RELATING TO AMENDMENTS TO "HYBRID" PROPOSAL The New York Stock Exchange has filed a proposed rule change with the Securities and Exchange Commission amending its “hybrid” market proposal.1 The proposed rule change contains additional information on the operation of the hybrid proposal as well as additional amendments to NYSE rules. The most significant aspects of the proposed rule change are summarized below. If you have any questions regarding the proposal or any comments you would like the Institute to consider including in its comment letter on the proposed rule change, please contact Ari Burstein by phone at 202-371-5408 or by e-mail at aburstein@ici.org. I. Broker Agency Interest File Under the hybrid proposal, brokers would have the ability to place within the NYSE’s Display Book an “agency interest file” at varying prices at or outside the best bid or offer with respect to orders the broker is representing. As originally proposed, this interest would not be publicly disseminated unless it is at or becomes the Exchange’s best bid or offer. Under the amendments to the proposal, however, when a broker’s agency interest is at or becomes the Exchange’s best bid or offer, only a minimum of 1,000 shares per broker would be required to be displayed.2 The displayed agency interest would be entitled to parity with other displayed orders at the best bid or offer price. Broker agency interest that is not displayed (“reserve interest”) would yield to displayed interest in the best bid or offer. Non-displayed agency interest at other prices, however, would continue to be on parity with all other orders, whether displayed or not. 1 The proposed rule change can be found on the NYSE’s website at http://www.nyse.com/pdfs/2004-05amend2.pdf. For a full description of the NYSE’s hybrid proposal, see Memorandum to Equity Markets Advisory Committee No. 37-04 and SEC Rules Committee No. 71-04, dated August 19, 2004 [17909]. 2 A broker would have discretion to display more than 1,000 shares of his or her agency interest at the best bid or offer. In addition, the actual amount of a broker’s agency interest, if less than 1,000 shares, would be displayed and included in the quote. 2 II. Specialist Interest File and Algorithm Under the hybrid proposal, specialists, through proprietary algorithms, would have the ability to systemically supplement the quote, determine price points outside the Exchange’s best bid and offer to which they want to provide liquidity, facilitate a single-price execution at the bid or offer price, and systemically match outgoing ITS commitments. The amendments provide further information on the specialist algorithm, including information on how the algorithm would permit specialists to electronically provide price improvement to automatic executions. Specifically, under the proposal, specialists could provide price improvement to automatic executions under the following conditions: (i) the

quotation spread is at least three cents; (ii) the specialist is represented in the published bid or offer in a meaningful amount, i.e., the lesser of 10,000 shares or twenty percent of the respective bid (offer) size; (iii) the order receiving price improvement is of “retail” order size, i.e., 2,000 shares or less and the specialist fills the order; and (iv) the price improvement provided by the specialist is (a) at least .02 where the quote spread is .03 - .05, (b) at least .03 where the quote spread is .06 - .10, (c) at least .04 where the quote spread is .11 - .20, and (d) at least .05 where the quote spread is more than .20. III. Liquidity Replenishment Points The hybrid proposal would include two types of “Liquidity Replenishment Points” or “LRPs” - a price-based LRP and a momentum-based LRP. When an LRP is reached, the automatic execution functionality on the Exchange would “shut off” and the quotation would not be available for automatic execution and would be designated as such. The original filing did not state the precise parameters for the momentum-based LRP. The amendments, however, clarify that the momentum-based LRP would be reached when the price of a security has moved the greater of twenty-five cents or one percent of its price, within 30 seconds or less.3 IV. Availability of Automatic Executions and Autoquote Under the original filing, during the time that a report of an execution was being made through the NYSE’s Display Book, automatic executions would have continued until the volume associated with the bid and/or offer decrements to 100 shares and then would have been suspended until the market is requoted. The amendments clarify that autoquote, but not automatic executions, would be suspended only during the time it takes to manually report a block-sized transaction. The amendments state that this would be the only instance in which manual reporting would cause the suspension of autoquote and may, under certain circumstances, cause the suspension of automatic executions. Once the hybrid market is implemented, all other instances of manual reporting, autoquote, and automatic executions would continue to operate without suspension. Ari Burstein Associate Counsel 3 The price-based LRP would be a minimum of five cents from the Exchange’s best bid or offer, rounded to the next nearest nickel.