

**MEMO# 19022**

July 18, 2005

## **DRAFT ICI LETTER ON NYSE PROPOSAL RELATING TO A HYBRID MARKET**

©2005 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [19022] July 18, 2005 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 23-05 SEC RULES COMMITTEE No. 42-05 RE: DRAFT ICI LETTER ON NYSE PROPOSAL RELATING TO A HYBRID MARKET The Securities and Exchange Commission has published for comment a proposed rule change filed by the New York Stock Exchange relating to the creation of a hybrid market.<sup>1</sup> The Institute has prepared a draft comment letter on the proposal. The most significant aspects of the draft letter are summarized below and a copy of the draft letter is attached. Comments on the proposed rule change are due to the SEC no later than July 20, 2005. If you have any comments on the draft letter, please contact the undersigned by phone at 202- 371-5408 or by e-mail at [aburstein@ici.org](mailto:aburstein@ici.org). Specialist Participation in the Hybrid Market The draft letter states that the Institute continues to be concerned about the types of information that specialists would have access to when interacting with investor orders in the hybrid market, when they obtain access to this information, and how this information is used in interacting with investor orders. Algorithmic Price Improvement Under the proposal, specialists will have the ability to algorithmically provide price improvement to incoming orders. The draft letter opposes providing such a functionality to specialists. The draft letter states that allowing specialists to electronically price improve incoming orders and, in effect, step ahead of investor orders on the Exchange's limit order book, runs counter to the NYSE's goal of providing incentive to investors to place orders onto the Exchange. The current proposal also modifies the parameters for providing such price improvement, significantly reducing the restrictions on specialists. The draft letter disagrees with the proposition stated in the Release that such a reduction preserves incentives for the 1 Securities Exchange Act Release No. 51906 (June 22, 2005), 70 FR 37463 (June 29, 2005) ("Release"). 2 limit orders on the display book to establish the best price or that the benefit of providing price improvement to incoming orders under such circumstances would outweigh the potential disincentives to post aggressive limit orders. Finally, the draft letter urges the Exchange to amend the proposal to provide floor brokers with the same ability to provide electronic price improvement to orders via a discretionary order type. The draft letter notes that this is a functionality that institutional investors have been requesting from the Exchange in order to level the playing field between specialists and investors in this area. Specialist Access to Trading Information Under the proposal, specialists, via the proposed specialist algorithm, would be permitted to send messages to the display book to quote or trade in reaction to specified types of information including, among other things, "incoming orders as they are entering NYSE systems." The draft letter opposes providing specialists with the ability to electronically "see" certain information before other market participants and to

make quoting and trading decisions based on that information. Broker Agency Interest File Under the proposal, floor brokers will have the ability to place on the Exchange's limit order book an "agency interest file" with respect to orders the broker is representing. While brokers would have the ability to completely conceal their orders from other market participants through this functionality (except at the best bid and offer), their orders would be executed on parity with investors' orders placed on the NYSE's display book, which are required to be displayed for the full size of the orders. The draft letter recommends that the Exchange amend the proposal to eliminate such a priority system and provide execution priority only to the portion of orders represented by floor brokers that are displayed. The draft letter states that fundamental market fairness should dictate that displayed orders should be protected and provided priority in the execution process over "hidden" orders and that such a system would reward market participants for displaying orders. If the Exchange determines not to make such a change, the draft letter recommends that investors be provided with their own reserve feature where they also would have the ability to conceal a portion of their orders (and not be required to do so solely through the use of a floor broker). Ari Burstein Associate Counsel Attachment (in .pdf format)

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