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INSTITUTE LETTER TO NYSE RECOMMENDING CHANGES TO ADDRESS BUYSIDE DECIMALIZATION CONCERNS

[13224] March 5, 2001 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 8-01 SEC RULES COMMITTEE No. 21-01 RE: INSTITUTE LETTER TO NYSE RECOMMENDING CHANGES TO ADDRESS BUYSIDE DECIMALIZATION CONCERNS The Institute recently sent a letter to the New York Stock Exchange addressing problems that mutual funds and other institutional investors have had trading large blocks of securities on the Exchange since the implementation of decimalization. In general, the letter states that decimalization, by itself, is not the problem and that decimalization simply has made more apparent the difficulties that mutual funds and other institutions commonly face when trading on the Exchange. In order to resolve these problems, the letter recommends that the NYSE implement certain changes to the NYSE's Institutional XPress system, which was created to facilitate the ability of institutional investors to trade large orders on the Exchange. In particular, Institutional XPress would provide that XPress orders, defined as an order of at least 25,000 shares to be executed against a displayed XPress quote (defined as a published bid or offer of at least 25,000 shares that is displayed at the same price for at least 30 seconds), be executed without the risk of being broken up by other market participants. A copy of the Institute's letter is attached and the Institute's recommendations are summarized below. A. Eliminate Institutional XPress Display Requirement and Reduce Required Number of Shares to Become XPress Eligible The letter recommends that the NYSE eliminate the 30-second display requirement in order for a quote to qualify as an XPress quote. In particular, the letter states that the display requirement is unnecessary, is especially inappropriate in today's fast-moving trading environment, and will only serve to provide a "free look" to market participants who want to step ahead of large orders. As a result, institutional investors, knowing that large limit orders on the book are not provided protection and are likely to be "penny jumped," have little, if any, incentive to place large limit orders on the Exchange. Eliminating the display requirement would therefore reduce stepping ahead, and, in turn, attract order flow and increase the depth and liquidity of the market. 2The letter also recommends that the number of shares required for quotes and orders to become XPress eligible should be reduced. The letter notes that a significant portion of the orders that mutual funds and other institutional investors typically place on the Exchange for execution are below the 25,000 share threshold established by the NYSE for Institutional XPress, especially in the case of smaller cap stocks. Therefore, many of the types of orders in which the XPress system was intended to facilitate trading will not be covered under the current rules. The letter states that reducing the number of shares required for a quote and order to become XPress eligible would encourage the placement of more orders on the

Exchange’s limit order book, further enhancing the liquidity on the Exchange. B. Eliminate Representation of XPress Orders by NYSE Specialists to the Crowd Under Institutional XPress, a specialist must represent an XPress order to the crowd prior to that order executing against an XPress bid or offer on the limit order book. The letter states that the practical effect of this requirement is that while the XPress order may receive price improvement (which could be by as little as one penny in a decimal environment), the large limit orders comprising the XPress quote go unexecuted. The letter notes that Institute members report that it is far more important for them to receive protection for their displayed orders than the price improvement provided by the XPress system. Consequently, the letter recommends that the NYSE revise Institutional XPress so that XPress orders placed by institutions would not be required to be represented by the specialist to the crowd, thereby promoting the placement of limit orders on the book by providing protection for, and rewarding the placement of, those orders. C. Allow XPress Orders to Reach Through to Orders on the Book Below the Best Bid and Offer The letter states that in order to ensure that Institutional XPress will offer mutual funds and other institutions the ability to execute large orders on the Exchange, the XPress system should allow those institutions to reach through to orders on the book that are below the best bid and offer. However, in order to ensure that bids or offers on the book that are superior to the XPress eligible quote are protected, and to be consistent with the Exchange’s desire to provide price improvement opportunities to smaller orders, the letter recommends that all orders on the book at prices better than the XPress eligible quote be required to be executed and price improved to the price of the XPress quote in these circumstances. Ari Burstein Associate Counsel Attachment Attachment (in .pdf format)

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