MEMO# 19033

July 21, 2005

ICI LETTER ON NYSE PROPOSAL RELATING TO A HYBRID MARKET

 [19033] July 21, 2005 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 25-05 SEC RULES MEMBERS No. 86-05 RE: ICI LETTER ON NYSE PROPOSAL RELATING TO A HYBRID MARKET The Institute has filed a comment letter with the Securities and Exchange Commission on a proposed rule change filed by the New York Stock Exchange relating to the creation of a hybrid market.1 The most significant aspects of the comment letter are summarized below and a copy of the letter is attached. Specialist Participation in the Hybrid Market The 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 letter opposes providing such a functionality to specialists. The letter states that allowing specialists to electronically interact with incoming orders in this manner 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 on the Exchange. The current proposal also modifies the parameters for providing such “price improvement,” significantly reducing the restrictions on specialists. The letter disagrees with the proposition stated in the Release that such a reduction preserves incentives for the limit orders on the display book to establish the best price. Similarly, the letter disagrees that the benefit of providing “price improvement” to incoming orders under such circumstances would outweigh the potential disincentives to post aggressive limit orders. 1 Securities Exchange Act Release No. 51906 (June 22, 2005), 70 FR 37463 (June 29, 2005) (“Release”). 2 Finally, the 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 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 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 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 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 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) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 19033, or call the ICI Library at (202) 326-8304 and request the attachment for memo 19033.

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