INVESTMENT COMPANY INSTITUTE

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NYSE PROPOSED RULE CHANGE RELATING TO THE IMPLEMENTATION OF A HYBRID MARKET

[17909] August 19, 2004 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 37-04 SEC RULES COMMITTEE No. 71-04 RE: NYSE PROPOSED RULE CHANGE RELATING TO THE IMPLEMENTATION OF A HYBRID MARKET The Securities and Exchange Commission has issued a notice of the filing of a proposed rule change by the New York Stock Exchange to implement enhancements to its existing automatic execution facility, NYSE Direct+, in order to create a "hybrid" market.1 Comments on the proposed rule change must be received by the SEC no later than September 7, 2004. 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 by August 27. A. Treatment of Orders and Quotes in Hybrid Market Under the NYSE's proposal, market orders and immediate or cancel ("IOC") orders would be permitted to be automatically executed on the Exchange. Similarly, limit orders to buy priced at or above the Exchange's published offer and limit orders to sell priced at or below the Exchange's published bid ("marketable limit orders") would be automatically executed, whether or not such orders are designated for automatic execution. Market orders not designated for automatic execution would be executed in the auction market as would non- marketable limit orders, even if designated "auto ex." The NYSE also would create a new order type called an "Auction Limit" or "AL" order. An AL order would provide the opportunity for price improvement and would be required to be designated as such when entered into the market. Finally, all quotes would be subject to automatic execution, unless designated otherwise. Non-auto-executable quotes also could be generated electronically when a "Liquidity Replenishment Point" ("LRP") (discussed below) is reached or by the specialist "gapping the quotation" due to an order imbalance.2 In such a case, a transaction, update of the 1 Securities Exchange Act Release No. 50173 (August 10, 2004), 69 FR 50407 (August 16, 2004) ("Release"). The NYSE's proposal can be found on the SEC's website at http://www.sec.gov/rules/sro/nyse/34-50173.pdf. 2 The Release states that the purpose of a gapped quotation would be to disseminate the existence of an order imbalance and minimize short-term price dislocation associated with such an imbalance by allowing appropriate 2 quote by the specialist, or a timer-generated quote update, would resume automatic executions and autoquotes. B. "Sweeping" the NYSE Display Book The NYSE's proposal provides for the unfilled balance of any "auto ex" market order or marketable limit order to "sweep" the book, automatically executing until it is filled, its limit price, if any, is reached, or an LRP is reached. Bids and offers on the Display Book between the displayed bid or offer and the sweep "clean-up" price would

receive price improvement at the “clean-up” price. Any balance remaining after the order reaches its limit price, if any, or an LRP is reached, would remain on the book for handling in the auction market where it would become a bid or offer at its limit price or the LRP price, whichever is reached first. If executed at the price at which it is bidding (offering), the balance would have priority; if executed at a different price (within the parameters of its limit, if any), the balance would trade on parity with the crowd. C. Liquidity Replenishment Points The NYSE is proposing to implement two types of LRPs - a price-based LRP and a momentum-based LRP. 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. A specified price movement over a specified period during a trading session would trigger the momentum-based LRP.3 In either case, 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. Autoquote would be suspended, although cancellations of orders would be permitted. When an LRP is reached, the specialist, crowd, and off-floor market participants also could enter orders to replenish liquidity on either side of the market.4 D. Interaction with Orders and Quotes in Other Markets Under the proposed hybrid market plan, ITS commitments to trade sent to the NYSE from another market center because the Exchange’s published bid or offer is the national best bid or offer (“incoming” ITS commitments) would be automatically executed to the extent of the time for the entry of offsetting orders or the cancellation of orders on the side of the imbalance. The Release further states that an imbalance could occur because of a sudden influx of orders on the same side of the market, the entry of one or more large-sized order(s) with little or no offsetting interest, or when a member proposes to effect a one-sided block transaction at a significant premium or discount to the prevailing market. 3 The Release states that the precise parameters for the momentum-based LRP are currently under review and would be identified at a later time and submitted as an amendment to the proposed rule change. 4 When an LRP is reached and no residual remains, or a residual remains and it is not capable of trading at a price above (in the case of a buy order) or below (in the case of a sell order) the LRP, autoquote would resume as soon as possible, but in no more than five seconds, unless in that time, orders came in that locked or crossed the market. If an LRP is triggered and a residual capable of trading at a price above or below the LRP remains, but does not lock or cross the market, autoquote would remain disengaged, and automatic executions could not occur until the specialist trades or requotes the market. However, autoquote and auto executions would resume in any event in no later than 28 seconds. Where a residual remains and it is capable of trading above (below) an LRP and it locks or crosses the market, autoquote and auto executions would not be available until a trade occurs or the specialist requotes the market. 3 volume of the Exchange’s published best bid or offer, and any unfilled balance would be automatically cancelled. Where the national best bid or offer is published by another market center in which an automated execution is immediately available, or such bid or offer is otherwise protected from a trade-through and the specialist has not systemically matched the price associated with such bid or offer, the Exchange would automatically route to the other market center the portion of a market or marketable limit order that would satisfy the better- priced bid or offer (“outgoing” ITS commitments). E. Role of Specialists and Floor Brokers in Hybrid Market Under the NYSE’s proposal, specialists 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 by bidding or offering on behalf of the dealer account, facilitate a single-price execution at the bid or offer price, and systemically match outgoing ITS commitments. The “specialist interest file” would not be publicly disseminated unless it is at the Exchange’s best bid or offer price. Specialist interest that establishes the best bid or offer would be entitled to priority with the crowd at that price for one trade. Specialist interest at other prices would yield to agency orders and the broker agency interest file (discussed below), except that once orders on the Display Book are filled, specialists could trade on parity with the crowd, including broker agency interest. Brokers would have the ability to place within the Display Book an “agency interest file” at varying prices at or outside the quote with respect to orders the broker is representing. This interest would not be publicly disseminated unless it is at the Exchange’s best bid or offer. Broker agency interest would have priority if it establishes the best bid or offer and would be on parity with other orders at its price. The broker’s agency interest also could serve to improve the price of a sweep order. The broker would be able to place agency interest in only one crowd at any given time and would be required to cancel his or her agency interest file when leaving the crowd. When the broker wants to trade as part of the crowd on the same side and at the same price as his or her agency interest, the broker would be required to add to the existing agency interest or cancel any agency interest at that price before verbally trading in the crowd. If the broker leaves the crowd without canceling his or her agency interest file and a trade occurs involving such interest, the broker would be held to that trade. Ari Burstein Associate Counsel

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