The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

July 21, 2005

Institute's Comments on NYSE Hybrid Market Proposal, July 2005

July 20, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: NYSE Direct+ (File No. SR-NYSE-2004-05)

Dear Mr. Katz:

The Investment Company Institute[1] is writing to comment on Amendment No. 5 to the New York Stock Exchange's proposal to create a hybrid market.[2] While the proposal is a significant step in bringing much needed automation to the NYSE, the proposal falls short of providing an effective trading system that will encourage investors to place orders on the Exchange.

As a preliminary matter, given the significance and potential impact of the hybrid proposal on the U.S. securities markets as a whole, we recommend that the new SEC Chairman and a full set of Commissioners consider the proposal and its broad implications, especially in light of the proposed NYSE merger with the Archipelago Exchange and the recent adoption of SEC Regulation NMS.

The Institute has commented previously on the hybrid filing,[3] noting the importance of the NYSE's proposal for investors and recommending several modifications to the proposal that would benefit investors in interacting with liquidity in an automated NYSE environment. The current version of the hybrid proposal does not implement those recommendations and makes additional changes to the proposal that would make it more difficult for investors to benefit from the proposed hybrid market. Most significantly, these changes relate to the methods in which specialists and floor brokers would interact with investor orders. We urge the NYSE to consider our recommended changes in this area, the most significant of which follow.[4]

Table of Contents

Specialist Participation in the Hybrid Market

The proposal provides several ways for specialists to participate in the hybrid market. Most significantly, specialists would be provided with several tools in which they could interact with incoming orders as well as quotes on the Exchange’s limit order book. Of continued concern to the Institute is the types of information that specialists would have access to when interacting with investor orders, 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 Institute opposes providing such a functionality to specialists. 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. Our members report that they are much more likely not to post orders on the Exchange due to the ability of specialists to electronically interact with orders through this mechanism.

The current proposal also modifies the parameters for this functionality, significantly reducing the restrictions on specialists. Under the proposal, specialists may “price improve” all or part of an incoming order as long as (1) the specialist is represented in the bid if buying and the offer if selling (i.e., for as little as 100 shares) and (2) they provide a minimal amount of improvement depending on the quotation spread.[5] Under prior versions of the hybrid proposal, specialists had to be represented in the published bid or offer in a “meaningful amount” (i.e., the lesser of 10,000 shares or 20% of the respective bid or offer size), the quotation spread had to be at least three cents in order to provide “price improvement” (as compared to two cents under the current proposal), and the amounts of improvement the specialist had to provide were larger.[6]

The Institute disagrees with the proposition stated in the Release that such a reduction in the “meaningful” amount with which the specialist must be represented in the published bid or offer preserves incentives for the limit orders on the display book to establish the best price. Similarly, we disagree that the benefit of providing “price improvement” to incoming orders under such circumstances would outweigh the potential disincentives to post aggressive limit orders. As discussed above, our members believe this functionality provides a strong disincentive to post orders on the Exchange.

The Exchange notes that it intends to provide floor brokers with the same ability to provide electronic “price improvement” to orders via a discretionary order type. This is a functionality that our members, as well as other institutional investors, have been requesting from the Exchange in order to level the playing field between specialists and investors in this area. We are disappointed that the Exchange has chosen not to make such a functionality part of the current filing and to delay providing such a functionality to investors until an undetermined future time. We urge the Exchange to amend the current filing to provide such a functionality.

Specialist Access to Trading Information

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 Institute 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 by, in particular, providing “price improvement” to incoming orders. Having the ability to see orders as they enter NYSE systems, and therefore before they reach the display book, creates an information advantage for specialists. While the Exchange has introduced requirements designed to ensure that specialists do not possess any speed advantage in reaching the display book, we believe, in order to prevent any potential conflicts of interest and to ensure a level playing field, that any specialist algorithm should not have access to such information in the first place.

Priority of Specialist Trades

Exchange rules currently prohibit specialists from trading for their proprietary account on parity with the “crowd” in situations where the specialist is establishing or increasing its position. The current proposal would amend Exchange rules to eliminate that restriction. The Release notes that the proposed change would increase the instances in which the specialist would be entitled to trade along with public customers and represents a shift from the overall scheme of priorities on the Exchange floor. The Institute opposes eliminating this restriction. Placing specialists trading for their proprietary account on parity with investor orders misaligns the interests of participants on the Exchange and, as such, is likely to contribute to the ineffectiveness of the hybrid system as a whole.

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. In our previous comment letters, we expressed concern regarding the lack of transparency of the broker agency interest file and the accompanying priority provided to a broker. Specifically, 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 Institute believes that fundamental market fairness should dictate that displayed orders should be protected and provided priority in the execution process over “hidden” orders. While parity may provide an incentive for crowd participation in the price discovery process, it does not provide such an incentive for investors. Our previous letters recommended that the Exchange provide execution priority on the same level as fully displayed investor orders only to the portion of those orders represented by floor brokers that are displayed. Those orders that are not displayed should yield to displayed interest, in the same manner as the hybrid market would operate at the best bid and offer. At the very least, brokers should be required to display a portion of the orders in the agency interest file, in order to increase transparency on the Exchange and to enable investors to be better informed of how many shares are available at each price level.

The amended proposal does not make any changes to this aspect of the hybrid market. The Release also does not offer any explanation why, when expanding the ability of floor brokers to place orders in a broker agency interest file at the best bid and offer, the NYSE chose to only provide parity to displayed agency interest and why they did not pursue such a priority system at other levels of the book. The Institute believes that such a system would reward market participants for displaying orders and may therefore provide incentive for investors to place orders on the Exchange. We therefore recommend that the Exchange amend the current filing to establish such a priority system. If the Exchange determines not to make such a change, at the very least, we recommend investors be provided with their own reserve feature so that 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).

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The Institute continues to offer its assistance to the NYSE as it moves forward in its plans to implement the hybrid market and is hopeful that the Exchange will make the changes necessary to make the hybrid market an effective trading system for investors. If you have any questions or need additional information, please contact me at (202) 371-5408.

Sincerely,
Ari Burstein
Associate Counsel

cc: The Honorable Cynthia A. Glassman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Harvey J. Goldschmid

Annette L. Nazareth, Director

Robert L.D. Colby, Deputy Director
Division of Market Regulation

Meyer Eisenberg, Acting Director
Division of Investment Management

John Thain, Chief Executive Officer
Robert G. Britz, President and Co-Chief Operating Officer
Catherine R. Kinney, President and Co-Chief Operating Officer
New York Stock Exchange

ENDNOTES

1 The Investment Company Institute is the national association of the U.S. investment company industry. The Investment Company Institute’s membership includes 8,521 open-end investment companies ("mutual funds"), 651 closed-end investment companies, 144 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about $8.036 trillion. These assets account for more than 95 percent of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 87.7 million, representing 51.2 million households. Many of the Institute's investment

adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 188 associate members, which render investment management services exclusively to non-investment company clients. These Institute members and associate members manage a substantial portion of the total assets managed by registered investment advisers.

2 Securities Exchange Act Release No. 51906 (June 22, 2005), 70 FR 37463 (June 29, 2005) (“Release”).

3 See Letters from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated September 22, 2004 and December 13, 2004.

4 The Institute continues to be concerned about the short periods of time provided to the public to comment on complex SRO proposals, such as the hybrid market proposal. Our concern, in this instance, is exacerbated by the comment period falling over the July 4th holiday.

5 When the quotation spread is two cents, algorithms must provide improvement of one cent; when the quotation spread is between three and five cents, algorithms must provide improvement of at least two cents; and when the quotation spread is more than five cents, algorithms must provide improvement of at least three cents.

6 Under prior versions of the proposal, when the quotation spread was between three and five cents, algorithms had to provide improvement of at least two cents; when the quotation spread was between six and ten cents, algorithms had to provide improvement of at least three cents; when the quotation spread was between eleven and twenty cents, algorithms had to provide improvement of at least four cents; and when the quotation spread was more than twenty cents, algorithms had to provide improvement of at least five cents.
