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Institute Comments on NYSE Hybrid Market Proposal, September 2004

September 22, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the New York Stock Exchange's proposal to enhance its Direct+ system in order to create a hybrid market.[2] The NYSE's proposal is an important step in implementing much needed automation on the Exchange.

The Institute welcomes the decision of the NYSE's new leadership to increase the automation of securities transactions. The Institute has, for several years, been recommending changes to the Exchange that would increase the automatic execution of orders and facilitate the more efficient trading of listed securities by investors.[3] We believe that more should be done, however, to make the Exchange an efficient trading venue. We therefore urge the NYSE to view the hybrid proposal as a first step towards improving trading on the Exchange and to continue to examine ways to provide for the increased automatic execution of orders, as well as the ability of investors to efficiently interact with those orders.

We have outlined below our initial views on the hybrid market proposal. Most significantly, in view of the vagueness and complexity of the proposed rule change as filed, we recommend that the NYSE supplement the filing with explanatory material to clarify how the hybrid market structure would operate and that the Commission provide interested persons with another opportunity to comment on the proposal prior to any final decision on the proposed rule change. In addition, we recommend several modifications to certain aspects of the proposal, in particular, how specialists would participate in the hybrid market as well as how the broker agency interest file would interact with other orders, in order to ensure that the hybrid market proposal works in the best interest of investors.

Our specific comments follow.

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Vagueness of Proposed Rule Change and Request for Supplemental Filing

The hybrid market proposal would provide for the automatic execution of orders on the Exchange at the published best bid or offer to the extent of the volume associated with such bid or offer. The unfilled balance would, to a limited extent, "sweep" the book until the order is executed, its limit price is reached, or an "Liquidity Replenishment Point" (discussed below) is triggered.[4]

As a preliminary matter, we believe the proposal, as drafted, does not sufficiently explain the operation of many fundamental aspects of the hybrid market proposal. Of particular concern to our members is how different types of orders placed on the Exchange would be executed under the proposal, including the priority of and interaction between those orders. In addition, it is unclear how specialists and floor brokers would interact with incoming orders and orders placed on the Exchange's limit order book. The proposal also is vague on how orders on the Exchange would interact with orders placed in other securities markets. Specifically, it is unclear if and when the Exchange would send orders to other markets to satisfy better or equally priced orders on those markets.

Another important concern to our members is the particular methods and frequency in which the automatic execution of orders in the hybrid market would be "shut off." For example, the Release states that during the time that a report of a manual execution is being made through the NYSE's display book, automatic executions would continue until the volume associated with the bid and/or offer decrements to 100 shares and then would be suspended until the market is requoted. The Release further states that automatic executions would then be suspended until the reporting is concluded. While it is unclear from the proposal how often such a situation would occur, the Institute is concerned that such a situation would not be infrequent or uncommon and that this could have a profound impact on the automatic execution of orders on the Exchange. There are several additional situations under which the automatic execution of orders would be shut off under the hybrid proposal for which we believe additional explanation is necessary. We will discuss our concerns regarding these situations in detail below.

Given the importance of the hybrid proposal, not only to the future operation of the NYSE but also to the interaction of the Exchange with other market centers, we recommend that the NYSE supplement its filing with detailed explanatory material, including specific examples, discussing how different types of orders available under a hybrid market structure would be executed as well as the methods and frequency with which the automatic execution of orders would be shut off. After such explanatory material has been filed with the Commission, we recommend that the Commission provide interested persons with another opportunity to comment on the proposed rule change prior to any Commission decision whether to approve the proposal.[5]

Specialist Participation in the Hybrid Market

The proposal would provide several ways for specialists to participate in the hybrid market. Specifically, 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. In addition, specialists would have certain methods in which they could, in effect, shut off the automation features of the hybrid market.

Specialist Interest File

The proposed rule change would provide the opportunity for specialists to use proprietary algorithms to supplement the quote and determine price points outside the Exchange's best bid and offer to which the specialist wants to provide liquidity. According to the Release, this could serve to improve a sweep price, facilitate a single-price execution at the bid or offer price, and match outgoing ITS commitments.[6]

The Institute is concerned with the types of information that specialists would have access to when developing their proprietary algorithm. Specifically, as we understand the proposal, specialists could access data on order characteristics of prior trades and could read incoming order characteristics in order to determine their participation criteria. In addition, specialists could have access to certain information regarding the broker agency interest file (discussed below). It is unclear from the filing, however, exactly what this data consists of and the specific information specialists would be privy to when developing their algorithm. The Institute recommends that the NYSE, in the supplemental filing recommended above, clarify the specific types of information that would be available to specialists.

The Institute also questions the specialists' need for this information in order to interact with orders placed on the Exchange. If the NYSE, however, believes specialists should be provided with this information, it is important that it also be accessible and available to other market participants. The availability of this information solely to specialists could provide them with an unfair advantage over investors in interacting with orders on the Exchange and, at the very least, creates an impression of unfairness.

Gapping the Quote

Under the proposed rule change, specialists could cause a quote to become non-auto-executable by "gapping the quotation." The Release states that the purpose of a gapped quote would be to disseminate the existence of an order imbalance and minimize short-term price dislocation associated with such imbalance by allowing appropriate time for the entry of offsetting orders or the cancellation of orders on the side of the imbalance.[7] Under the proposal, the size of an imbalance suitable for gapped quoting would be at least 10,000 shares or a quantity of stock having a value of $200,000 or more.

The Institute believes that investors would be best served by having their orders automatically executed without any disruption. Nevertheless, if the NYSE believes that trading halts through mechanisms such as gapping the quote are necessary for its market, rules governing the gapping of quotes should be structured in a manner to permit this procedure as infrequently as possible. We recommend that the NYSE examine whether the parameters required to gap a quote make sense in the current market environment and whether such parameters should be raised. Specifically, for certain types of stocks, an imbalance of at least 10,000 shares or a quantity of stock having a value of $200,000 or more may not be that significant and may permit the excessive shut off of the automation portion of the hybrid market.[8]

Broker Agency Interest File

Under the proposed rule change, brokers would have the ability to place on the Exchange's limit order 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 at the Exchange's best bid or offer and 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, except specialist interest.

The Institute is concerned with the lack of transparency of the broker's 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, their orders would be executed on parity with investors who are required to display the full size of their orders. Permitting this runs counter to the Exchange's goal of providing incentive to place orders onto the Exchange as investors would be reluctant to place orders if they know they will not be rewarded for taking the risk of displaying those orders.

The Institute recommends that in order to be on parity with other orders at its price, brokers be required to display orders placed under the broker agency interest file. At the very least, brokers should be required to display a significant portion of those orders. In this manner, transparency of orders on the Exchange would be increased and investors would be better informed of how many shares are available at each price level. Such a requirement also would provide incentive to investors to place orders on the Exchange's limit order book. If the Exchange believes that brokers should have the ability to conceal all or a portion of their orders from other market participants, we recommend that those orders not be provided priority on the same level as fully displayed investor orders and that the Exchange provide investors with a reserve feature where investors 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).

Liquidity Replenishment Points

Under the proposed rule change, the unfilled balance of an auto-ex market order or a marketable limit order would sweep the book until, among other things, a "Liquidity Replenishment Point" or "LRP" is reached. When an LRP is reached, the quotation would not be available for automatic execution and the NYSE would change to a non-automated market. The NYSE proposes two types of LRPs – a price-based LRP and a momentum-based LRP. While the Release states that "a specified price movement over a specified period during a trading session would trigger the momentum-based LRP," the Release further states that the precise parameters for this type of LRP would be identified at a later time and would be submitted as an amendment to the proposed rule change.[9]

While we question the need for LRPs to curb volatility on the Exchange, if the NYSE believes they are necessary to dampen volatility during electronic sweeps, we recommend that the Exchange clearly delineate the parameters of the momentum-based LRP in the supplemental filing discussed above.[10] In addition, we recommend that the NYSE provide additional information in a supplemental filing on the operation of both types of LRPs, specifically how often they expect the LRPs to be reached (and therefore automation on the Exchange to be shut off) as well as how the LRPs will be disseminated to market participants.

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The Institute appreciates the opportunity to provide comments on the NYSE's proposal. If you have any questions or need additional information, please contact me at (202) 371-5408.

Sincerely,

Ari Burstein
Associate Counsel

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins

The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid

Annette L. Nazareth, Director
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About the Investment Company Institute
The Investment Company Institute's membership includes 8,600 open-end investment companies ("mutual funds"), 630 closed-end investment companies, 135 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about $7.351 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 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 includes229 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.

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. More information about the Institute is available at the end of this letter.

[2] Securities Exchange Act Release No. 50173 (August 10, 2004), 69 FR 50407 (August 16, 2004) ("Release"). See also Securities Exchange Act Release No. 50277 (August 26, 2004), 69 FR 53759 (September 2, 2004), extending the comment period for the proposed rule change until September 22, 2004.

[3] See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Richard A. Grasso, Chairman, New York Stock Exchange, dated March 1, 2001.

[4] Under the proposed rule change, several types of orders would remain ineligible for automatic execution. The Institute believes that investors would benefit most if as many order types as possible would be executed automatically. We recommend that the NYSE examine whether certain of these order types could be made eligible for automatic execution in the hybrid market and, if not, the reasoning why these order types should be ineligible.

[5] While the proposed rule change also has broader implications for the Commission's proposed Regulation NMS, we will limit our comments to the specific provisions of the NYSE's hybrid market proposal. We note that many of the Institute's comments in our letter on the Commission's Regulation NMS proposal, however, address issues pertinent to the future structure of the Exchange. See Letter from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 30, 2004.

[6] Under the proposal, the specialist interest file would not be publicly disseminated unless at the Exchange best bid or offer price. In addition, 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, except that once orders on the book are filled, specialists could trade on parity with the crowd, including broker agency interest.

[7] 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.

[8] We also recommend that the NYSE provide data in a supplemental filing on how often it expects the quote to be gapped in a hybrid market structure.

[9] The price-based LRP would be set at nickel increments, at least five cents from the best bid or offer.

[10] Given the importance of having the minimal amount of disruption to automation as possible, we also recommend that the NYSE permit the sweeping of orders on the book beyond the proposed limits for the price-based LRP. The Institute also believes that it is very important that once an LRP is reached, the automatic execution functions of the hybrid market resume as soon as possible so as to result in minimal disruption to automation on the Exchange. The Institute therefore recommends that the NYSE examine whether the timeframes and conditions discussed in the proposed rule change under which automatic executions would resume after an LRP is reached should be reduced.