



Securities Industry Association

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October 1, 2004

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

Re: Proposed Rule Change by the New York Stock Exchange Relating
to the Exchange's Direct+ Trading Facility (SR-NYSE-2004-05)

Dear Mr. Katz:

The Securities Industry Association ("SIA")¹ appreciates the opportunity to comment on proposed rule changes by the New York Stock Exchange ("NYSE" or "Exchange") to the Direct+ system that would create a hybrid market model. The NYSE states that the hybrid market would enable customers to execute more of their orders quickly and electronically, with certainty and anonymity, while at the same time retaining elements of an auction market.² According to NYSE Chief Executive Officer John Thain, the proposal offers more options for trading, which will contribute to market quality.³

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 790,600 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated \$213 billion in domestic revenue and an estimated \$283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

² Securities Exchange Act Release No. 50173 (August 10, 2004), 69 FR 50407.

³ Remarks by John Thain, Chief Executive Officer, NYSE, at press conference held on August 2, 2004 announcing the filing of proposed changes to NYSE Direct+.

While the SIA strongly supports the NYSE's efforts to expand automation in its market, the current proposal is incomplete and lacks important details and concrete examples of how the system will operate in practice. We believe it is difficult to evaluate the effects of the proposal without more information. In fact, the market structure impact of this proposal is comparable to the Nasdaq Stock Market's ("Nasdaq") SuperMontage, which we note required numerous amendments in order to provide sufficient detail to elicit meaningful comment. Only with such additional information can we understand completely how the hybrid market will operate, and be assured that it contributes to fair and orderly markets, fosters competition among markets, and protects investors.

SIA does not oppose or support the proposal at this point. Rather, our intent is to express our concern that the current proposal provides an insufficient basis for the Commission to grant approval of these sweeping changes, and to identify certain areas where clarification or examples are necessary to more fully assess the proposal. Because an informed discussion would necessarily involve a more complete understanding of the system proposed, the industry should have the opportunity to provide additional comments after the NYSE has provided additional information and clarification.

As discussed in more detail below, given the significance of the proposal and the potential impact it will have on the fundamental structure of the equities markets, SIA member firms believe more completeness and specificity is needed in a number of areas. Clarification is needed with respect to specialist and floor broker trading (specifically, the specialist interest files and the floor broker agency interest files), the mechanics of limiting sweeps (including the operation of Liquidity Replenishment Points, or "LRPs"), order handling for the new class of orders designated "Auction Limit," and how the NYSE's new system will interact with the Intermarket Trading System ("ITS"). Additionally, there are concerns with how this proposal will interface with the Regulation NMS proposal.

I. Specialist and Floor Broker Trading

The filing does not provide sufficient information with respect to how NYSE floor members will participate in the hybrid market. The proposal provides for specialist interest files and floor broker agency interest files that are not necessarily displayed unless a quotation in either happens to be the best bid or offer. This raises questions about the appropriateness of creating a hidden reserve book for those with a time and place advantage relative to the rest of the marketplace. Specifically, we have questions regarding the consistency with the Securities Exchange Act of 1934, particularly Section 11(a), of such time and place advantages in the context of a more automated market, and note that Regulation ATS does not allow for such informational advantages.

According to the filing, floor brokers will have the ability to place within the Display Book system an agency interest file at varying prices at or outside the quote with respect to orders the broker is representing. It appears that floor brokers' orders outside the national best bid and offer will be undisclosed to the public. SIA believes further

information on this new class of undisclosed orders called “floor broker agency interests” is needed. For example, what is the effect of and public policy reasons for this new class of orders? This element of the proposal relating to floor brokers' orders may raise questions about priority and parity. It is unclear whether floor brokers' orders could take priority over the limit orders of public investors that may be priced at only one penny away from the floor brokers' undisclosed interests. If a floor broker's undisplayed order can, in fact, trade ahead of another investor's order priced at a penny better, then the floor broker, like all market participants, should be required to display at least a minimum amount (similar to the ability in Nasdaq to display 100 shares with hidden reserve), so that market participants are aware of the trading interest. The filing also needs to have more specificity regarding priority and parity when a floor broker has a hidden order at the same price as a displayed investor order. The NYSE proposal is silent on this point, but we would oppose any concept that was unfair to investors whose prices are displayed.

Additionally, the filing lacks detail on the role of specialists, including their ability to influence stock prices when trading for their own account. More information is needed on how priority and parity will work with respect to the specialist file and whether orders in those files have any priority or precedence over incoming orders. Also, it is not clear how the specialist would “systematically supplement the Exchange's published bid or offer.” Specialists have the opportunity to supplement liquidity, and may be able to do so by devising algorithms based on data to which others do not have access. If this is the case, it would seem unfair to allow specialists to use such proprietary algorithms that are based on prior trades and data not available to other market participants. Similar to the floor brokers' undisclosed interests noted above, some hidden specialist trading interests may be included in a sweep of the limit order book, and thereby affect investors' displayed orders. Accordingly, we believe the NYSE should provide more information regarding how the specialist file will work.

II. Mechanics of Limiting Sweeps

Under the proposed rules, the unfilled balance of an order designated for automatic execution or a marketable limit order will “sweep the book” until it is executed, its limit price, if any, is reached, or a LRP is reached. LRPs are volatility moderators and are either price-based or momentum-based. For example, the price-based LRP will be a minimum of \$.05 from the NYSE bid (or offer) rounded to the next nearest nickel. On a percentage basis, this is a very small price move (less than 1/2 of one percent on a \$20 stock).⁴ The NYSE should explain their rationale for this uniform level across all stocks and also provide details for the momentum-based LRP, which, according to the filing, are still being worked out. As LRPs effectively disable Direct+, these details are essential to understanding the proposal and must be addressed before a meaningful assessment of the proposal can be rendered.

⁴ By way of comparison, Nasdaq has a 10% speed bump on SuperMontage orders to dampen excess volatility. The use of a fixed percentage takes into account differences in stock price and may be a more appropriate measure of LRP.

Because the NYSE can unilaterally cut off a sweep with LRPs, the LRP standards must be clear. The industry needs to understand who has the authority to order such a suspension, when a suspension may be ordered, how news of a suspension will be disseminated, and how frequently such suspensions are expected to occur. It would be helpful to see specific examples of how LRPs will operate and how they will affect existing orders. For example, it would be helpful to know whether the NYSE will disseminate an identifier for a quote that is subject to an LRP. Also, the NYSE should provide estimates of how often they believe each type of LRP would be reached under a variety of normal and abnormal market conditions (*e.g.*, market open/close, resumption of trading after a trading halt, initial public offering ("IPO"), or rebalance event). The rule filing states that cancellations of orders will be permitted when a LRP is reached or the autoquote is otherwise suspended, and yet it does not describe whether the process is electronic/immediate or whether it will involve manual handling. Finally, the length of time that a LRP could stop auto executions is a potential concern. Again, it is not clear whether this means at each price level or what impact this will have on sweeps. The filing states that automatic execution is not available when trade reporting is taking place and size decrements to 100 shares.

SIA believes the NYSE needs to provide more information on the mechanics of limiting sweeps, *i.e.*, when the NYSE can preclude investors from obtaining an automated sweep of the limit order book and also the number of seconds the stock will remain in an auction capacity or "slow" mode.⁵ Such information has implications as to whether the NYSE is truly a "fast" market under proposed Regulation NMS. This is important information that is critical to informed public comment. The SEC should not approve this filing until this information has been reviewed and published for comment.⁶

III. Order Handling

Under the proposal, the NYSE proposes to create a new order type—Auction Limit orders. SIA believes the proposal should describe in more detail how the new class of orders will be handled and how they will interact with existing order types. Specifically, the proposed rules state that an Auction Limit order or market order not designated for automatic execution will be displayed on the book at the minimum variation better than the exchange bid or offer "if not executed upon entry." It is not clear how such orders would be executed upon entry, *i.e.*, whether this is an automated or manual process and whether there is an opportunity for price improvement. If it is a

⁵ Under this proposal (specifically, the changes proposed for NYSE Rule 60), we understand that the stock could be considered "slow" under different scenarios and time parameters. We believe that this could be confusing to investors, and would advocate a more simplistic approach.

⁶ The proposed sweep function also needs to be considered in relation to the proposed pilot program in Regulation SHO; specifically, the effect a sell short sweep order would have under the pilot where consecutive bids are hit should be studied. Specific details on how the sweep function will operate in connection with short sales should be provided.

manual process, the rules should be specific about the timeframe within which the specialist must execute before the order will be quoted in the Display Book.

It would also be helpful to see examples of how the rules operate after an Auction Limit or market order hits the Display Book. The proposal should describe in detail how orders will be executed (with what priority and at what price) when Auction Limit orders, non-auto-execution-designated market orders, and ordinary market and limit orders interact.

The rule filing also contains no specific provisions for IPOs, short sales, or Rule 10b-18 orders. The NYSE should discuss how such tick-sensitive orders will be handled.

IV. Interface with ITS and Regulation NMS

How the NYSE will interact with ITS and other markets is an important concern in and of itself, and also as it relates to the SEC's Regulation NMS proposal. It is not clear how the proposal interacts with ITS and the existing trade through rule ("TTR"); more explanation on this point would be helpful. For example, what would be the impact of a TTR (current, as well as that proposed in Regulation NMS) when the automatic execution facility shuts down? Likewise, will the NYSE enact rules relating to the responsibilities of specialists or other Exchange members towards Display Book marketable orders that could be electronically executed in another execution venue during the LRP period?

These issues are particularly relevant when considering the Commission's proposed Regulation NMS. It is important to understand how the hybrid model would work under the proposed TTR, which will depend on a distinction between "fast" and "slow" markets (or possibly on a distinction between a "fast" and "slow" quote as advocated by many commenters on Regulation NMS). For example, if the NYSE's hybrid model includes an electronic execution facility that may frequently be switched on and off (such as due to LRPs), this raises questions as to whether the NYSE will be considered a "fast" or "slow" market. Also for example, would the NYSE quote be considered slow during the LRP interval? If so, some firms believe the NYSE's quote should not be included in the national best bid and offer at all, or only when the electronic execution facility is accessible. More detail is necessary to answer these important questions.

There are also concerns that certain electronic orders will be able to sweep the specialist's limit order book by trading a small amount of shares at the best bid or offer and then trading the remaining shares at inferior price points. In this regard, the NYSE proposal could circumvent any TTR via a small offer of shares that matches the best offer elsewhere and execution of the balance of the trade at mostly inferior prices. More information on access under the NYSE proposal is necessary to address these concerns. In fact, we strongly recommend that the SEC review the NYSE filing in conjunction with its deliberations on Regulation NMS.

As indicated above, SIA believes that the SEC should not grant "fast" market status to any marketplace until all of the details of its electronic platform (including how it will interact with existing rules and manual market conventions, *e.g.*, gapping the quote, short sales, and G orders) are published and subject to public comment. It has been suggested that the NYSE may advocate retaining ITS as a network for intermarket communications, but without the application of present ITS rules or the intervention of the present ITS operating committee and structure. How this would work with regard to trade through protection, the satisfaction of other markets' better prices, access fees, etc. is all related to the NYSE's hybrid market model. We need to fully understand how these issues will be addressed with a more complete filing, including concrete examples of the operation of the proposed rules.

V. Conclusion

Given the far-reaching impact of the Direct+ proposal, it is essential that the NYSE provide a complete explanation of the proposed system and its interaction with the existing regulatory framework and market practices before approval is granted. The current proposal requires a greater level of detail and more illustrative examples in order to evaluate the merits of the proposal. While we applaud the NYSE for taking an important step towards providing a marketplace with more options for trading, the rule filings in support of such a system should be clear and complete. We look forward to the opportunity to provide additional comments as more information becomes available.

The SIA appreciates this opportunity to provide comments on the NYSE proposal. If you have any questions or require additional information, please contact the undersigned at 212-608-1500, or Ann Vlcek, Associate General Counsel, at 202-216-2000.

Sincerely,

Donald D. Kittell
Executive Vice President

cc: Chairman William H. Donaldson
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