INVESTMENT COMPANY INSTITUTE

December 13, 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 amendments to the New York Stock Exchange's proposal to create a hybrid market.[2] As the Institute stated in its comment letter[3] on the original hybrid filing,[4] the NYSE's proposal is an important step in implementing much needed automation on the Exchange. In that letter, we also recommended several modifications to certain aspects of the proposal. While the amendments are an improvement over the original filing, we believe certain modifications continue to be necessary to address our concerns in several areas, most significantly, how the "broker agency interest file" would interact with other orders on the Exchange.

As a preliminary matter, given the Commission's decision to publish a revised form of proposed Regulation NMS for public comment (the details of which have not yet been released), it is unclear how those revisions will impact the operation of the proposed hybrid market or if further changes to the hybrid market proposal will be necessary in order to meet the terms of Regulation NMS. Our comments are, therefore, limited to the hybrid proposal based on our understanding of how it would operate under the originally proposed version of Regulation NMS.

Broker Agency Interest File

In our comment letter on the original hybrid filing, the Institute expressed concern regarding the lack of transparency of the broker agency interest file and the accompanying

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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. 50667 (November 15, 2004), 69 FR 67980 (November 22, 2004) ("Release").

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

4 Securities Exchange Act Release No. 50173 (August 10, 2004), 69 FR 50407 (August 16, 2004).

priority provided to a broker.[5] Specifically, while the broker agency interest file, as originally proposed, would not be publicly disseminated, orders in that file 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. Permitting this parity runs counter to the Exchange's goal of providing incentive to place orders onto the Exchange, as our members report they will continue to be reluctant to place orders onto the display book if they know they will not be rewarded for taking the risk of displaying those orders.

The Institute addressed this issue in our initial comment letter by recommending that the non-displayed orders placed under the broker agency interest file not be provided priority on the same level as fully displayed investor orders. We also recommended that, at the very least, brokers 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 implement such a system. However, in expanding the ability of floor brokers to place orders in a broker agency interest file to the best bid and offer (and not only to price levels below the best bid and offer, as originally proposed), the NYSE is requiring brokers to display a minimum of 1,000 shares per broker[6] and *only* the *displayed* agency interest at the best bid or offer would be entitled to parity with other displayed orders at the bid or offer price. Broker agency interest at the best bid or offer that is not displayed ("reserve interest") would yield to displayed interest in the best bid or offer. 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. It remains unclear from the proposal, however, why the NYSE chose to pursue such a priority system solely at the best bid and offer and not at other levels of the book.

While the Institute does not object to the Exchange providing floor brokers with the ability to represent their customers as they do today in the auction market (*i.e.*, by working orders in the crowd), 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. We therefore recommend 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.

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[5] The "broker agency interest file" would provide brokers with 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.

[6] A broker would have the discretion to display more than 1,000 shares of his or her agency interest at the best bid or offer.

<u>Momentum-Based Liquidity Replenishment Point</u>

Under the hybrid market proposal, the automatic execution of orders would be shut-off when a "Liquidity Replenishment Point" or "LRP" is reached. The amended proposal provides further information on one type of LRP, the momentum-based LRP ("MLRP"). Specifically, the MLRP would be based on the movement of prices over a specific period of time and would be reached when the price of a security has moved the greater of 25 cents or one percent of its price, within 30 seconds or less.[7]

The Institute is concerned that the proposed parameters for the MLRP may be too restrictive in the current market environment, especially for very liquid stocks that may reach the proposed parameters within a very short period of time. We therefore recommend that the NYSE examine existing market data to ensure that these parameters are appropriate. In this manner, the Exchange may prevent the excessive shut-off of the automation portion of the hybrid market.[8]

<u>Transparency of Information</u>

In our initial comment letter on the hybrid market proposal, the Institute noted that under the hybrid market, certain types of information would be unavailable to investors. For example, much of the information that specialists would be privy to when developing their proprietary algorithm would not be available to investors, *e.g.*, the aggregate amount of broker agency interest at each price level.[9] The Institute therefore recommended that the hybrid proposal be amended to make this information available to investors. The amended proposal, however, does not address this concern. We continue to believe that 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 therefore reiterate the recommendation made in our prior comment letter.

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[7] MLRP ranges would be calculated using the high and low trades on the Exchange within the prior 30 seconds.

[8] Under the hybrid proposal, there are a number of circumstances, in addition to LRPs, where the automatic execution of orders would be shut off, *e.g.*, specialists gapping the quote. As we stated in our prior comment letter, investors would be best served by having their orders automatically executed with minimal disruption. We therefore reiterate our recommendation that the proposed rules governing halts and the resumption of automation be reexamined to ensure that they are structured in a manner to permit the least amount of disruption as possible.

[9] We note that such aggregate information also could be included in a specialist's response to a member's market probe in accordance with NYSE rules.

The Institute appreciates the opportunity to provide comments on the NYSE's amended proposal. If you have any questions or need additional information, please contact me at (202) 371-5408 or Amy Lancellotta at (202) 326-5824.

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 8,585 open-end investment companies ("mutual funds"), 636 closed-end investment companies, 141 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about $7.565 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 87.7 million as of mid 2004, 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 228 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.