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Annette L. Nazareth, Esq.
Director, Division of Market Regulation
Robert L. D. Colby, Esq., Deputy Director,
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: Amendment No. 1 to File No. SR-NYSE-2004-05
Relating to Amendments to NYSE Direct+

Dear Ms. Nazareth and Mr. Colby:

I am writing on behalf of Fidelity Investments to offer our initial response to the filing by the New York Stock Exchange of its proposal to establish a so-called "Hybrid Market." The NYSE has characterized its proposal as affording investors a limited ability to obtain automated, immediate execution of trades on the NYSE.

Our immediate reason for writing is to caution that the NYSE proposal, as filed, is written in a fashion that is so prolix that it seriously impedes the ability of investors and other interested persons to understand the proposal and thereby offer informed comments to the Commission. If the proposal had implications solely for NYSE's own market, that would be one matter. But, this is not the case. The proposal has far reaching implications for competition among markets and for the proposed trade-through rule that is the centerpiece of the Commission's proposed Regulation NMS. It is clear to all concerned that the NYSE proposal is intended to confer on the NYSE – or at least part of the NYSE's market – the status of being a "fast" market or offering "fast" quotes. In turn, that would bring the NYSE within the "protection" of the trade-through rule, if the Commission adopts that rule.

As you know, we submitted comments to the Commission on June 22, 2004 opposing the trade-through rule because we believe that investors should be free to make their own informed judgments in choosing the market center in which to trade. A trade-through rule would impede

competition among market centers on matters that bear directly on best execution – including efficiency, reliability, transparency, fairness, innovation and all-in costs to investors. Whether investors favor or oppose a trade-through rule, however, the NYSE proposal must be re-filed to allow informed comment by investors and other interested persons. We recommend that the Commission:

1. Direct the NYSE to re-file its proposal and to include as an attachment a "plain English" explanation.

2. Set forth as additional attachments, concrete examples of how the proposed limited, automated sweep of bids or offers on the NYSE's specialist book would work.

    i. One example should show how the limited sweep could be cut off by a so-called "momentum liquidity refreshment point." This example should specify the price movements and time frame which could trigger this cutoff.

    ii. A second example should show how the undisclosed trading interests of floor brokers and the specialist could be included in a sweep of the limit order book, and the impact that this can have on displayed public limit orders that may thereby be excluded from receiving execution.

    iii. A third example should show the impact on publicly displayed, firm orders on other market centers, including orders that match the NBBO as well as orders that are higher offers to buy or lower offers to sell than orders (including undisplayed trading interests of NYSE specialists and floor brokers) that are eligible to be swept on the NYSE.

3. Hold a public hearing at which representatives of the NYSE would explain their proposal and interested persons could offer their views on the proposal.

Although we are still seeking clarification of major portions of the NYSE's proposal, we would offer some preliminary views:

<u>The NYSE proposal has major gaps</u>.

The NYSE proposes to allow some electronic orders to "sweep" the specialist's limit order book, that is, to trade first at the best bid (quotation to buy) or offer (quotation to sell) and then to trade at price points inferior to the best offer or inferior to the best bid.

The NYSE has proposed that a sweep, however, can be cut off by a so-called "liquidity replenishment point" ("LRP"). One cut-off is "price-based" and is triggered when the market

price crosses a threshold set somewhere between 5 cents and 9 cents from the best bid or offer on the NYSE.

A second cutoff is triggered by a so-called "momentum-based LRP" that the NYSE's filing does not explain. Indeed, the NYSE acknowledges this, stating that "the precise parameters for the momentum-based LRP are under review and will be identified at a later time."

The NYSE's ability to cut off automated executions in its market is key to an understanding of its proposed hybrid market. Indeed, the uncertainty surrounding when, and under what conditions, the NYSE can unilaterally cut off the ability of investors to obtain an automated sweep of the limited order book may be enough disincentive against sending automated orders to the NYSE. One important point, unclear in the NYSE's filing, is this: Who can suspend automated executions? Must a floor governor do so? Or, does the specialist have the power or discretion to do so?

Much of the NYSE proposal is unexplained.

In many instances, the NYSE has not adequately explained the operation of its proposal or the reason for its key elements. For example, the proposal would create a new class of undisclosed orders called "floor broker agency interests." These orders, although undisclosed to the public, would appear to take priority over the limit orders of public investors that may be priced at only one penny away from the floor brokers' undisclosed interests. The practical effects of these undisclosed orders, and the public policy reasons for them, are not discussed in the NYSE filing.

The NYSE proposal appears to run directly counter to the Commission's purpose in proposing a trade-through rule in Reg NMS.

The NYSE has publicly supported a trade-through rule as "protecting" limit orders across markets. The NYSE has, for example, stated that its cornerstone principle is best price: "every order, regardless into which market it is entered, should compete with every other order and receive the best price, period."[1] Although we oppose a trade-through rule because we believe that investors should be free to choose the markets in which to trade – and to take a number of factors into account in seeking best execution – the Commission's own proposal of a trade-through rule is based on the notion that the government should adopt a rule that prevents a market from executing trades at a price that is inferior to limit orders at a superior price that are publicly displayed and immediately available for execution at another market.

[1] NYSE, Testimony of John A. Thain, Chief Executive Officer, and Robert G. Britz, Chief Operating Officer, at SEC Hearings on Regulation NMS (April 21, 2004), available at: http://www.sec.gov/spotlight/regnms.htm.

It is striking, therefore, that the NYSE hybrid market proposal, designed to confer "fast market" status on the NYSE, would appear to pave the way for systematic and recurring trade-throughs of firm bids and offers on other markets that are superior to the prices at which limit orders will be eligible to be swept on the NYSE. Suppose, for example, that offers to sell on the NYSE specialist's book are at the following prices:

- $10.00 for 100 shares
- $10.04 for 100 shares
- $10.06 for 400 shares
- $10.07 for 400 shares
- $10.09 for 1000 shares

Suppose also that a competing market center, for the same stock, has publicly displayed offers to sell at the following prices:

- $10.00 for 500 shares
- $10.01 for 500 shares
- $10.02 for 500 shares
- $10.03 for 500 shares

Now, assume that an investor wants to purchase 2000 shares. As we understand the NYSE proposal, the investor's order, if sent to the NYSE for automatic execution, would be filled at the following prices:

- $10.00 for 100 shares
- $10.09 for 1900 shares

As a result, publicly displayed orders at $10.01, $10.02, and $10.03 on the other market center would be traded through. The NYSE would have no obligation, under its proposal, to re-route automatically any portion of the 1900 shares to the other market where superior prices are available for immediate execution. We would note that this is not a question as to whether the Commission should require a consolidated limit order book (a "CLOB") to require time priority for limit orders across markets. It is a question of price priority, the very purpose that the Commission seeks to achieve with a trade-through rule.

Because the Commission's proposed trade-through rule has no exception for minimum size bids or offers, it seems quite likely that the NYSE hybrid market proposal, if approved by the Commission, will afford the NYSE specialist the ability to program his systems to automatically put up a pre-emptive 100 share bid or offer to match the NBBO at any given time on any other market. As a result, if the Commission adopts its trade-through rule, the NYSE would *never* be obligated to send trades to another market as long as its specialists match the NBBO with a minimum bid or offer. Even if the NYSE specialist declines to do so, the NYSE would be required to send only that (small) part of an automated order to another market that is quoting the best bid or offer. The NYSE specialist can keep the rest of the trade for execution on

the NYSE at prices inferior to those displayed on other markets. Under these circumstances, it seems seriously open to doubt whether a trade-through rule, if adopted by the Commission, would promote the interests of investors in any meaningful sense.

As noted, Fidelity opposes the trade through rule because it is unnecessary: any rational investor (especially one acting as a fiduciary) will invariably seek best execution wherever firm trades are immediately and unconditionally available. But those who advocate a trade-through rule (and oppose the opt-out right), we strongly suggest, should consider what remains of limit order price protection across markets if the NYSE sweep proposal is approved by the Commission, and the NYSE is thereby deemed to offer fast quotes.

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We are continuing to review the NYSE proposal, but if matters as important as these remain unexplained, we do not think commenters will have been given an adequate basis to evaluate the filing and we think the Commission will be left without sufficient explanations. For those reasons, we respectfully suggest that the Commission should direct the NYSE to re-file its proposal along the lines discussed above, and should hold a public hearing to explore the full implications of the proposal for the future structure of our nation's equity markets.

Respectfully submitted,

Eric D. Roiter

cc: The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Harvey J. Goldschmid, Commissioner
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