

## Letter on NYSE Decimalized Trading, March 2001

March 1, 2001

Mr. Richard A. Grasso  
Chairman  
New York Stock Exchange  
11 Wall Street  
New York, NY 10005

Dear Mr. Grasso:

The Investment Company Institute<sup>1</sup> is writing in connection with certain problems that mutual funds and other institutional investors have faced when trading on the New York Stock Exchange. As you know, since the implementation of decimalization on the Exchange, the execution of large orders has been hampered by reduced depth of the Exchange's limit order book and by increased instances of market participants stepping ahead of orders by increments of as little as one penny.

Some market participants reportedly contend that the problems noted above have arisen solely as a result of decimalization and are suggesting either that decimalization be reversed, or that the Exchange establish a minimum trading increment of greater than one penny (e.g., a nickel). We disagree. Decimalization, by itself, is not the problem. Rather, it has simply made more apparent the difficulties that mutual funds and other institutions commonly face when trading on the Exchange.

In order to address these problems, we strongly recommend that the NYSE implement certain changes that would facilitate the ability of mutual funds and other institutions to trade large orders on the Exchange. We recognize that the NYSE has developed a system specifically designed for these types of orders – Institutional XPress. Unfortunately, as discussed below, we do not believe that Institutional XPress, as presently constituted, will satisfactorily respond to the difficulties that institutions are experiencing. With certain changes, however, Institutional XPress could achieve its objectives and, in turn, allow all investors in NYSE-listed securities to reap the benefits of decimalization.

Our specific recommendations are set forth below. As a preliminary matter, we wish to stress the point that, while mutual funds are correctly viewed as institutional investors because they frequently execute large-sized orders, mutual funds do so on behalf of millions of predominantly middle-income investors. The median income of a U.S. mutual fund shareholder is \$55,000.<sup>2</sup> Moreover, 45% of all assets in Section 401(k) retirement plans are invested in mutual funds.<sup>3</sup> Thus, the principal beneficiaries of our recommended changes will be middle-income Americans.

### Institutional XPress

In approving the rules implementing Institutional XPress, the Securities and Exchange Commission stated that "the XPress system should encourage market participants, particularly institutional investors, to display orders of at least 25,000 shares, which may attract more order flow and increase the depth and liquidity of the Exchange's market to the benefit of investors and the public interest."<sup>4</sup> The Institute strongly supports this objective. Unfortunately, Institutional XPress, as currently structured, will do nothing to achieve it and instead represents a classic missed opportunity.

Our members consistently tell us that, without protection for large limit orders placed on the Exchange's limit order book and the assurance that they will be able to interact with those orders, they will be dissuaded from placing limit orders on the Exchange, thereby reducing the market's depth and liquidity. This effect has become more pronounced following the introduction of decimalization. In fact, preliminary data has shown that liquidity and depth in the market have already been reduced (reflected in a decrease in both the amount of limit orders on the Exchange and the amount of block trades being executed on the Exchange).

The Market Structure Report of the NYSE's Special Committee on Market Structure, Governance, and Ownership stated that, in connection with the introduction of decimalization, "[i]t is possible that unanticipated trading strategies may develop that will warrant

or require adjustments to [the NYSE] initiatives or changes in regulation."<sup>5</sup> The Report has proven to be prescient, and the following changes to Institutional XPress are now warranted:

1. Eliminate the required displayed time for a quote to qualify as an XPress quote and reduce the number of shares required for quotes and orders to become XPress eligible. Under NYSE rules, an XPress quote is defined as a published bid or offer of at least 25,000 shares that is displayed at the same price for at least 30 seconds. An XPress order is defined as an order of at least 25,000 shares to be executed against a displayed XPress quote, or at an improved price.

The 30-second display requirement is unnecessary, and is especially inappropriate in today's fast-moving trading environment. In its order establishing XPress orders and quotes, the Commission stated that the 30-second requirement would provide brokers and non-XPress orders the opportunity to interact with the quote before it becomes XPress eligible. In practice, however, this delay will only serve to provide a "free look" to market participants who want to step ahead of large orders. As a result, institutional investors, knowing that large limit orders on the book are not provided protection and are likely to be "penny jumped," have little, if any, incentive to place large limit orders on the Exchange. In this way, the required displayed time defeats the purpose of Institutional XPress. Eliminating it would reduce stepping ahead, and thereby attract order flow and increase the depth and liquidity of the market.

The number of shares required for quotes and orders to become XPress eligible also should be reduced. A significant portion of the orders that mutual funds and other institutional investors typically place on the Exchange for execution are below the 25,000 share threshold established by the NYSE for Institutional XPress, especially in the case of smaller cap stocks. Therefore, many of the types of orders in which the XPress system was intended to facilitate trading will not be covered under the current rules. Reducing the number of shares required for a quote and order to become XPress eligible would encourage the placement of more orders on the Exchange's limit order book, further enhancing the liquidity on the Exchange.<sup>6</sup>

2. Make XPress orders ineligible for price improvement, i.e., XPress orders should not be represented by the specialist to the crowd. Under Institutional XPress, a specialist must represent an XPress order to the crowd prior to that order executing against an XPress bid or offer on the book. The practical effect of this requirement is that while the XPress order (i.e., the responding order) may receive price improvement (which could be by as little as one penny in a decimal environment), the large limit orders comprising the XPress quote go unexecuted. Thus, in its desire to ensure that the institution responding to an XPress quote receives price improvement, the NYSE has created a regime that strongly discourages the entry of those orders that would comprise the XPress quote in the first place. For this reason, those institutions, including mutual funds, that would receive the "benefit" of this price improvement would gladly forego it. Our members report that it is far more important for them to receive protection for their displayed orders. Consequently, notwithstanding the NYSE's commitment to continuing to offer price improvement for smaller, retail orders, the Exchange should revise Institutional XPress so that XPress orders placed by institutions would not be required to be represented by the specialist to the crowd. This would promote the placement of limit orders on the book by providing protection for, and rewarding the placement of, those orders.<sup>7</sup>

3. Allow XPress orders to reach through to orders on the book below the best bid and offer and require all orders on the book at prices better than those orders to be executed and price improved. Decimalization has led to an increase in the number of price levels at which orders are entered, as well as a decrease in the volume represented at each price level. Consequently, in order to ensure that Institutional XPress will offer mutual funds and other institutions the ability to execute large orders on the Exchange, the XPress system should allow those institutions to reach through to orders on the book that are below the best bid and offer. For example, if a large limit order (at a size that is XPress eligible) is located two price levels below the best bid or offer, an incoming XPress order should be able to reach through and hit that limit order. In order to ensure that bids or offers on the book that are superior to the XPress eligible quote are protected, and to be consistent with the Exchange's desire to provide price improvement opportunities to smaller orders, we would further recommend that all orders on the book at prices better than the XPress eligible quote be required to be executed and price improved to the price of the XPress quote in these circumstances.<sup>8</sup>

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By enhancing Institutional XPress in the ways set forth above, the NYSE could help ensure that all investors – including millions of mutual fund shareholders – will realize the full benefits of decimalization. We therefore strongly encourage the Exchange to make these changes. We would be pleased to discuss our recommendations with you further. If you would like to do so, or if you have any questions regarding this letter, please contact the undersigned at (202) 326-5815 or Ari Burstein at (202) 371-5408.

Sincerely,

Craig S. Tyle  
General Counsel

cc: The Honorable Laura S. Unger, Acting Chairperson

The Honorable Isaac C. Hunt, Jr., Commissioner  
The Honorable Paul R. Carey, Commissioner  
Annette L. Nazareth, Director, Division of Market Regulation  
Robert L.D. Colby, Deputy Director, Division of Market Regulation  
Paul F. Roye, Director, Division of Investment Management  
Securities and Exchange Commission

Catherine R. Kinney, Group Executive Vice President  
Edward A. Kwalwasser, Group Executive Vice President  
New York Stock Exchange

## ENDNOTES

<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,414 open-end investment companies ("mutual funds"), 489 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.937 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

<sup>2</sup> See Investment Company Institute *Mutual Fund Fact Book* (40th ed.) at 46.

<sup>3</sup> See *Fundamentals: Investment Company Institute Research in Brief*, Vol. 9, No. 2 (May 2000) at 7.

<sup>4</sup> Securities Exchange Act Release No. 43763 (December 21, 2000), 65 FR 83120 (December 29, 2000) at 83122.

<sup>5</sup> Market Structure Report of the New York Stock Exchange Special Committee on Market Structure, Governance and Ownership, p. 22.

<sup>6</sup> The Institute recognizes that the Exchange has indicated that it may, in the future, reduce the minimum size for XPress orders and quotes to 15,000 shares and reduce the minimum required display time for XPress quote designation to 15 seconds. We believe, however, that these types of changes are crucial to the workings of Institutional XPress and should be made prior to the implementation of the system. In addition, for the reasons noted above, we do not believe that any minimum required displayed time is appropriate.

<sup>7</sup> The Institute also recommends that the NYSE eliminate the 3:58 p.m. cut-off time for entering XPress orders, because the cut-off, the purpose of which is to allow sufficient time for a specialist to represent the XPress order to the crowd for price improvement, would no longer be necessary if XPress orders were ineligible for price improvement.

<sup>8</sup> In order to implement this change, it will be necessary for the Institutional XPress rules to allow a quote below the best bid or offer to become XPress eligible and for the definition of XPress order to be amended to eliminate the requirement that an XPress order be for no more than the displayed size of an XPress quote.