

**To: NYSE Members and Member Firms**

**Re: Hybrid Market Update**

The NYSE is preparing to launch Phase III of our four-phase Hybrid Market initiative. This program is designed to:

- Address customers' requests for greater access to the NYSE's quotes via automatic execution, in an effort to provide more choice and flexibility in trading;
- Improve efficiency by 1) providing floor brokers and specialists with new and improved tools to respond to customers more quickly and directly; and 2) eliminating little-used, complicated order types; and
- Meet the Reg. NMS compliance deadline of Feb. 5, 2007.

**Recently Filed and Approved Changes**

Following the approval of the NYSE Hybrid Market by the SEC in March 2006, the NYSE continued to talk with customers and constituents about the initiative. Those discussions raised a number of possible additional refinements, and the NYSE responded by seeking SEC approval for several of those requests. As the Hybrid Market progresses into its final stages of implementation, we thought it would be useful at this time to summarize these recent changes, which we expect to become effective with the start of Phase III on Oct. 6, 2006, pending SEC approval:

**What Has Changed?**

**Auto-execution orders**

The NYSE will automatically execute any market or limit order that is marketable against the NYSE quote up to 1 million shares. Customers will no longer need to mark the orders as "NX" to auto-execute; the NYSE by default will auto-execute them.

In addition, the NYSE will accept Immediate or Cancel orders and either execute them, route them, or cancel them back to the customer instantaneously.

Orders that are executable beyond the best bid or offer will automatically sweep to the point of completing the order or the order hits an LRP.

**Electronic Sweeps**

The NYSE originally proposed allowing electronic orders to automatically execute at the displayed best bid and offer of the NYSE and sweep up or down, replicating block trades in the physical floor auction – that is, with a trade at the inside and a trade at the clean-up price. Orders on the Display Book between the best price and the clean-up would receive the superior clean-up price and be considered price improved.

Customers responded that they would rather have executions at each price point between the best and the final execution price. The NYSE agreed to make this change.

Block-sized trades manually sweep the auction market essentially unchanged from current execution procedures. See section on Rule 127 below.

## Openings and Closes

In general, the NYSE's opening and closing procedures will remain the same with these exceptions: auto-execution will continue right through to the close; opening and closing trades are exempt from trade-through requirements; and the quote after the opening may result in routing to better quoted markets.

## Liquidity Replenishment Points (LRPs)

The NYSE originally proposed LRPs to address two types of volatility emanating from electronic executions: volatility from individual consecutive orders and from consecutive electronic sweeps with clean-up prices. Because the electronic sweep has been modified to execute at individual prices, there is only a need for one LRP.

The new LRP replaces the two originally filed and approved. In its new form, the LRP has been simplified to a set of values added to and subtracted from the last sale, acting as a buffer against excessive volatility and briefly reverting to manual auction-style executions to properly reflect all pricing interest at once.

The LRPs are recalculated and applied every 30 seconds, published by the NYSE in real time, and the values will be available at nyse.com. The NYSE has filed for a range of possible values based on a stock's volume and price, and as an implementation strategy intends to start with the most restrictive LRPs in each category. Even with this approach, the NYSE expects fewer than 10,000 LRPs a day, against a daily rate of almost 15 million quotes. The NYSE plans to move to the less restrictive values sometime after full cutover and after reviewing the performance of the LRPs.

For LRPs that do not result in a lock or cross, the market will republish automatically. As originally filed, that time frame was 5 seconds. Based on recent feedback from customers preferring to ease into the new LRP, the NYSE filed for approval of a range between 5 to 10 seconds to go fast again. The NYSE will begin at 10 seconds and over time move to 5 seconds.

## Stop Orders

Historically, the NYSE has provided for both stop and stop-limit orders. Today, these order types represent a very small percentage of orders received. In an effort to simplify the NYSE market and in recognition that firms and customers themselves provide for this type of market minding, the NYSE will eliminate stop-limit orders, and convert stop orders to market orders that will automatically execute when elected.

Specialists will no longer have access to stop orders and their electing prices. They will have the opportunity to provide price improvement to the resulting market order after the stop has been triggered. As a result, specialists will no longer guarantee execution prices when their trading elects stop orders.

## Rule 127 Trades

Rule 127 trades are block trades executed manually in the auction market. Typically, they result in a sweep at two execution prices: the clean-up price and a penny inside the clean-up. In recognition of Reg. NMS and the best-quote rules, Rule 127 trades will now include a trade at the best bid or offer in addition to the two prices mentioned above.

## **Automatic Routing to Best Prices / Automatic Execution of Incoming ITS Orders**

When the NYSE starts to cut over securities in Phase III, orders and reports in the Display Book will be automatically routed to the best published quotation price for those securities. In addition, floor brokers interested in accessing away markets will be able to do so by routing orders to the Display Book (via DOT, Direct+ or e-Quote); those orders will automatically access the best quoted price nationally, quickly and in compliance with all NYSE and SEC routing rules.

Trades executed between brokers in the crowd must be at prices at or better than the National Best Bid or Offer. These trades will not be subject to routing and will be marked as either Sold or Sold Last as appropriate. The Display Book will determine the need to mark the trades with the proper identifier and the specialist will remain responsible for reporting these trades.

During the Phase III rollout, the expiration time used by market centers for ITS orders will generally be 30 seconds, although most market centers will automatically execute these orders. Over time, the expiration timer will be moved to 5 seconds.

Orders received by NYSE from other markets through ITS will automatically execute as Immediate or Cancel orders against the NYSE top of book. There will be no sweeping available for these orders.

The ITS participants have agreed to change the governance of ITS and to continue to make the system available during the transition to the Reg. NMS environment. In addition, ITS participants have agreed that the free access normally accorded ITS participants no longer applies. Participants will charge transaction fees for ITS routed and executed business.

NYSE order-routing fees for equities will be set at 2.5 cents per 100 shares, consistent with NYSE transaction fees. Order routing fees for ETFs will be set at our current ETF transaction fee of 30.0 cents per 100 shares. While NYSE routes orders out infrequently, the new fees will enable NYSE to recover a portion of the costs imposed on the NYSE by other markets, enhance our ability to provide low cost order execution, and help maintain a simplified pricing and billing structure for our customers.

## **Floor Agent Capabilities**

NYSE floor agents will have pegging capabilities available to them for all e-Quotes and d-Quotes. D-Quoting capabilities will be enabled as securities are cut over in Phase III. Additional d-Quote capabilities will be available starting in Phase IV, prior to Reg. NMS becoming effective.

## **Specialist Stabilization Requirement Changes**

In recognition of the changing nature and dynamics of the markets, the NYSE has recommended changes to the stabilization requirements imposed on specialists when trading for their own account.

Today's stabilization requirements reflect a pre-decimal, tick-based, non-automated environment, when the specialist was responsible for reporting executions and updating quotes and had control over the pricing of orders. In view of a combination of factors -- decimal pricing, the NYSE's introduction of both automated trading (Direct+) and automated quoting (better-priced limit orders systemically update the quote with no specialist interaction), and the final implementation stages of the Hybrid Market, in which previous restrictions to automated trading are removed -- tick tests will become irrelevant and specialist's ability to control pricing will be eliminated in normal trading.

In recognition of these changes, the NYSE has recommended to the SEC changing the stabilization rules to no longer reference tick tests for specialist trading at and in between the best bid and offer. This would be applicable to all stocks. The second change recommended by the NYSE is that specialists be allowed to trade at the best bid and offer, and have re-entry requirements on the contra side. This change would apply to only the most-active listed issues. In this way, specialists would be allowed to more freely enhance the market by contributing their capital and liquidity.

These changes are currently under discussion with the SEC and are not effective with the Oct. 6 start of Phase III. The effective date of these changes is dependent on SEC approval.

### **Exempt Securities**

In the original Hybrid Market proposal in February 2004, the NYSE contemplated exempting certain securities from trading in the Hybrid Market due to their high price and the potential cost of errors using the auto-execution facility. In discussion with such listed companies, several indicated that they would prefer to be included in the program. As a result, the NYSE filed to increase the threshold for inclusion to \$1,000 per share from \$300 per share. This change will limit to three securities the exclusion from the Hybrid Market.

### **Additional Information**

These rule filings and additional information about these changes are available at [nyse.com/hybrid](http://nyse.com/hybrid), including training tutorials, regulatory information memos and the HybridTalk blog.

If you have any questions please do not hesitate to call:

Ed McMahon, Senior Vice President  
212.656.4708  
[emcmahon@nyse.com](mailto:emcmahon@nyse.com)

Angela Stulley, Senior Vice President  
212.656.6913  
[angela@nyse.com](mailto:angela@nyse.com)

Robert Airo, Vice President  
212.656.5663  
[rairo@nyse.com](mailto:rairo@nyse.com)

Laura Morrison, Managing Director  
212.656.4066  
[lmorrison@nyse.com](mailto:lmorrison@nyse.com)