October 11, 2005

Dear SEC:

I am writing with respect to the above-referenced rule submission, as well as to the attempted "clarification" of that submission presented in SR-NYSE-2005-69.

In my September 22, 2005 comment letter on SR-NYSE-2005-57, I indicated that the NYSE had abused the Commission's rule approval process in seeking expedited approval of a purported "systems enhancement" that in fact changed, in certain significant particulars, the dynamics of stop order and CAP-DI order execution (principally, no exposure to trading crowds to provide contra side liquidity as well as price improvement). After reviewing the NYSE's "clarification," I can only conclude that I was in error in using the term "abuse." The correct term is "egregious abuse."

I have commented on a number of recent NYSE rule submissions (SR-NYSE-2004-70 and SR-NYSE-2004-05) and expressed dismay at the NYSE staff's (at times) virtually incoherent and contradictory treatment of the NYSE's own rules, and the NYSE staff's failure to acknowledge and discuss the impact on the order execution process of the NYSE's own initiatives. The NYSE's responses to my criticisms (see, e.g., the NYSE's letter of June 7, 2005, and my June 15 2005 response thereto on SR-NYSE-2004-70, as well as my forthcoming response to their September 21, 2005 letter on SR-NYSE-2005-05), far from ameliorating matters, in fact demonstrate the depth of the NYSE staff's ignorance and their inability to analyse matters coherently and join issue with the actual criticism being made. A recent conversation with several NYSE floorbrokers shed light on this phenomenon for me. Apparently there has been significant staff turnover at the NYSE, and the new staff is widely perceived on the NYSE trading floor as being bright, honorable, and dedicated but lacking real, in-depth knowledge. It seems clear that the current NYSE staff are simply overmatched intellectually by the demands placed upon them by the new NYSE managemnt, who, as outsiders, have no real understanding of the subtleties and nuances of the NYSE's regulatory framework.

What the NYSE Submitted in SR-NSE-2005-57 for Immediate Effectiveness

In seeking expedited approval, the NYSE in SR-NYSE-2005-57 represented to the Commission (and to the public) that it was simply proposing to "sytematize certain functions that are currently performed manually regarding the execution of elected stop and CAP-DI orders and converted CAP-DI orders. The rules regarding the election and execution of CAP-DI and stop orders and the conversion and execution of CAP-DI orders remain the same."

In the NYSE's view, its proposal qualified for the SEC's expedited approval process (no prior public comment) because it was a simple sytems enhancement that did not involve any substantive change to the NYSE's order execution process (the only grounds upon which the SEC's expedited approval could have been obtained).

In my September 22, 2005 comment letter, I pointed out in specific detail exactly how the NYSE proposal raised serious, substantive issues with respect to the order execution process that in fact required full public comment prior to SEC approval. While I expressed significant reservations about the substantive matters raised, my immediate concern was with the integrity of the Commission's rule approval process. No SRO should be permitted to circumvent the normal SEC procedure with respect to a proposal raising significant public order execution issues.

The NYSE's Response: The Abuse of the SEC's Process Is Far Worse Than First Appeared

In a staggerly bizarre attempt (SR-NYSE-2005-69) at "clarifying" its earlier proposal, the NYSE has in fact demonstrated an almost comical cluelessness with respect to fundamental logic and applicable law, much less its own rules. And, as I have noted in other correspondence, it continues to be clear that the NYSE's lawyers no longer review in any meaningful way its rule submissions.

In its "clarification", the NYSE noted that trading crowd orders would continue to participate in executions against elected stop and CAP-DI orders by being "electronically represented" on the Display Book. Further, the NYSE represented that elected CAP-DI orders are not required under current rules to be exposed to the auction for price improvment because, if they were so exposed, they might "miss the market" if an NYSE Direct order (automatic execution) took away the contra side liquidity while the order was being so exposed.

In SR-NYSE-2005-57, a 23-page submission, the NYSE made virtually no reference whatsoever to its "hybrid market" proposal (one non-material reference in a footnote). In its "clarification", however, an 18-page submission, the NYSE makes at least a dozen references to the proposed "hybrid market", and how this proposal will operate therein.

Far from simply "clarifying" its earlier proposal, the NYSE's purported "clarification" in fact casts the earlier rule submission in an entirely different light. SR-NYSE-2005-57, by its plain terms, represented to the SEC and the public that the NYSE was seeking to put into immediate effect a proposal to remove stop and CAP-DI orders from the auction and instead provide for automated execution of those orders. Critical here was the NYSE's representation that it was simply "systematizing" a routine manual execution process.

In the "clarification", however, the SEC and the public are told that, in fact, implementation of the proposal is contingent upon SEC approval of the "hybrid market" rules, as SR-NYSE-2005-57 would be implemented pursuant to the "systematizing" of trading crowd interest as contemplated by the "hybrid market" proposal.

The problems in law and logic in the "clarification" defy belief, as does the idea that SR-NYSE-2005-57 could have been submitted in good faith in the first instance without the "clarifying" material.

It is clear from the "clarification" that SR-NYSE-2005-57 is in fact part and parcel of the "hybrid market" proposal, as stop and CAP-DI orders would be executed against contra side interest that is "systematized" in accordance with the "hybrid market" rules. But the problem here is obvious: the "hybrid market" proposal (in its current form) is clearly in trouble, given the serious issues raised by me and other commentators, and it is unlikely that the Commission can approve it as is. The "systematizing" of trading crowd and specialist interest (involving the creation of hidden limit order books), the granting to the specialist the ability to compete directly with public orders where he/she has never been permitted to do so, and the abandonment of the NYSE's historic price improvement methodology all raise serious public interest concerns to which the NYSE has singularly failed to adequately respond. (The NYSE's September 21, 2005 comment letter on SR-NYSE-2004-05 attempting to respond to criticisms of the "hybrid market" proposal can only be described as pitiful, as I will demonstrate in a forthcoming response).

Given the serious problems commentators have noted with the "hybrid market" proposal, the NYSE can not be permitted to surreptitiously "spin off" what are clearly "hybrid market"-related matters (as the NYSE did in SR-NYSE-2005-57 until they were forced to "come clean" by submitting the "clarification") and "end run" the normal prior public comment process so as to obtain SEC approval, with no prior public comment, of matters that are in fact quite controversial when fairly presented and fully understood, and are intrinsically part of the "hybrid market" proposal.

The "logic" employed by the NYSE in submitting SR-NYSE-2005-57 goes something like this: The NYSE is entitled to "immediate effectiveness" because its proposal is a mere "systems enhancement" with respect to an order execution process that does not yet exist, may never exist, but even if it should ever exist its final form is currently unknowable. And, further, immediate effectiveness is appropriate becuse it will not change the order execution process under rules that do not yet exist, may never exist, but, in the event, are currently unknowable as to any final form. This is astonishing stuff (one could not make it up if one tried) but yet this is the plain English translation of the NYSE's "clarifying" attempt to put the cart before the horse.

Surely, there is no such concept under federal law or SEC rules as immediate effectiveness of something that is contingent upon something else that does not yet exist. And the NYSE's representations that actual implementation of SR-NYSE-2005-57 is contingent upon prior SEC approval of the "hybrid market" proposal are both insulting and meaningless (as though it could otherwise be implemented). "Contingent immediate effectiveness" with respect to what is really a highly controversial underlying matter is simply a bizarre, unknown concept and is legally indefensible under SEC rules.

The NYSE contends (in footnote 9 of the "clarification") that the SEC's approval order granting immediate effectiveness of SR-NYSE-2005-57 "allows it to do the necessary systemic programming and roll-out of the programming, which will not be active until the Hybrid Market initiative is approved...." This can only be described as absolute, total rubbish as a matter of law. Neither the NYSE nor any other SRO needs an SEC approval

order to be "allowed" to engage in whtever form of contingent systemic programming it believes appropriate.

But there is real public harm if the SEC approval order is allowed to stand:

1. Notwithstanding the NYSE's pro forma acknowledgement that SEC approval is still contingent, the mere issuance of the approval order implicitly conveys to the public the impression of a favorable SEC pre-disposition to the underlying schematic for "systematizing" orders, notwithstanding serious, substantive public order protection issues as to which the SEC staff appear deeply troubled.

2. In obtaining immediate effectiveness, the NYSE did not even submit specific, enumerated rules, or amend existing rules, to codify exactly how stop and CAP-DI orders would in fact be executed. As I have demonstrated in my September 22, 2005 comment letter, the notion that the NYSE is simply "systematizing" the auction market's manual execution process is absurd, as there are obvious and significant differences. The public cannot be asked to intelligently review and comment on SR-NYSE-2005-57 in the absence of specific, codified rules, and references to the problematic hybrid market rules in their current, controversial form only exacerbate the difficulty of intelligent public response. It simply cannot be ascertained from SR-NYSE-2005-57 (much less the muddled "clarification") exactly how, ultimately, stop and CAP-DI orders would in fact be executed.

3. Nothing in SR-NYSE-2005-57 (much less the the "clarification") even discusses, much less justifies, the adverse impact on the quality of public order executions (e.g., the absence of price improvement).

4. The approval order, by restating the NYSE representations, fails to consider the adverse impact on the quality of public order executions, and implicitly endorses the NYSE staff's misunderstandings of the NYSE's rules.

5. If the approval order is allowed to stand, the NYSE is thereby permitted to "get away with" what was obviously a matter not fully or fairly (even with the bizarre "clarification") represented to the Commission or to the public in the first place.

It is clear that the Commission must rescind its approval of SR-NYSE-2005-57. The Commission should insist that the proposal and its "clarification" be resubmitted (under the normal, not expedited, process), with appropriate rule text language, as amendments to SR-NYSE-2004-05 (the "hybrid market" proposal). The public must be gven a full and fair opportunity for comment in the context of the proposed regulatory environment in which the proposal would in fact be implemented.

The "Clarification": Stop Orders

In my comment letter of September 22, 2005, I proceeded on the assumption that the NYSE was seeking to implement its proposal immediately in the existing physical

auction, as there was nothing presented to the contrary in SR-NYSE-2005-57, and "immediate effectiveness" is presumed to mean just that. The "clarification" makes clear that the NYSE had something radically different in mind (so much for fair notice in SR-NYSE-2005-57). But my comments that the proposed execution methodology represents a significant departure from how orders are executed in the current physical auction continue to be entirely valid, as the NYSE is clearly proposing to remove elected stop and CAP-DI orders from the physical auction, a significant market structure change that obviously renders the proposal ineligible for immediate effectiveness.

With respect to elected stop orders, price improvement is clearly possible in the physical auction as the specialist is required under Rules 76/91 to expose the orders to any trading crowd interest before completing an execution. There is no possibility for price improvement in SR-NYSE-2005-57. Furthermore, the dynamics of order execution change significantly under the proposed "electronic representation" (a bogus term if ever there was one) of floor broker orders. These orders are electronically transmitted on the trading floor to the Display Book, where they go on a separate, largely hidden limit order book and compete on highly advantageous, "parity" terms with the public limit order book. (See my comments on SR-NYSE-2004-05 on the myriad problems here). Only orders that have been previously transmitted to the Display Book can receive an execution as contra side interest subsequently enters the market for automatic execution. The floor broker, in reality, is no more "representing" the electronically transmitted order than an institution is "representing" a Superdot limit order it electronically transmitted to the public limit order book. In each case, neither the institution nor the floor broker has any control over the actual execution of the order.

The proposed "electronic representation" in no way replicates an actual trading crowd in the physical auction. The NYSE refuses to acknowledge a critical distinction here: in the physical auction, a floor broker can make an immediate, on-the-spot decision to effect a trade with a stop order after it is elected and exposed to the market. In the "electronic representation" market, the floor broker has to have made a decision to transmit an order to the Display Book before any contra side interest is present (i.e., before a stop order is elected) and will not otherwise receive an execution. This distinction can have signifiant consequences as to the price received by an elected stop order. For example, a stop market order to buy may be elected by a trade at .30, with the lowest "electronically represented" offer on the Display Book being priced at .40. Under the NYSE's proposal, the stop order would receive an immediate, automatic execution at a price of .40. But in the physical auction, a floor broker could make an immediate, on-the-spot trading decision to offer the elected stop order a price lower than .40 as that order is exposed to the market.

While one may debate the merits of physical versus "electronic" representation of orders, several points are inarguable: moving from physical to automatic execution changes the execution dynamic, has adverse pricing consequences, and involves far more than simply "systematizing" a manual execution process. By no conceivable legal standard is SR-NYSE-2005-57 ("clarification" or no) eligible for immediate effectiveness.

Furthermore, I note that the NYSE has made no response whatsoever in its "clarification" to my point that its proposed automated execution of stop orders can result in execution prices far removed fom the electing sale price, a result that is unheard of in the physical auction where the specialist is required to intervene to maintain fair and orderly market.

The "Clarification": CAP-DI Orders

Nothing is more illustrative of the current NYSE staff's lack of in-depth knowledge than their treatment of CAP-DI orders and the clear requirement in NYSE rules to expose these orders (as all orders are so required) to the auction market for possible price improvement. In its "clarification", the NYSE makes the following statement: "Therefore, according to Rule 13, a CAP-DI order is executed at the price of the electing transaction. By exposing a CAP-DI order to the market, there is a chance that a CAP-DI order would "miss the market" because of an automatic execution through Direct+ against the prevailing bid/offer before the CAP-DI order could be executed." This is the only rationale offered by the NYSE as to why CAP-DI orders (alone among all order types on the NYSE) are not subject to auction market order exposure rules.

The NYSE's position is nonsensical for the following reasons:

1. The NYSE has always represented that CAP orders (in all their various forms) are to be executed puruant to auction market rules when they are elected. An elected order is, under NYSE rules, simply a limit order, and the definition of a limit order in Rule 13 clearly states that it is to be executed at its limit price, or at a better price, when the order is represented. The CAP-DI order, as represented by the NYSE when it was adopted, was simply intended to allow the specialist to cancel an order that could not be executed when it was elected. The NYSE has never made any representations that elected CAP-DI orders are not to be executed pursuant to auction market procedures, or that elected CAP-DI orders are not eligible for price improvement. NYSE Rules 76 and 91 require auction market exposure of all orders in all cases. They do not provide an exception for CAP-DI orders, which they would have to do (with SEC approval) in order for the NYSE staff's current position to be sustainable.

2. The NYSE's rationale with respect to the Direct system is laughable. CAP-DI orders were introduced several years before the implementation of the Direct system. Therefore, CAP-DI orders could not possibly have been developed with an auction market exception premised on a system that did not then exist. When the Direct system was introduced, the NYSE did not change its order exposure rules one iota for any order type, much less for CAP-DI orders. In fact, the NYSE emphasised the exact opposite position. NYSE marketing propoganda consistently touted "platforms of choice", whereby a customer could obtain a non-price improved automatic execution (Direct) or conventional order exposure/price improvement executions under the rules applicable to all orders in the physical auction.

3. The NYSE is correct that a Direct order exposed for price improvement can receive a worse price if Direct takes the contra side liquidity as the order is beng exposed. But this is a meaningless truism, because it is similarly true of absolutely every other order type as it is exposed to the auction. The NYSE can not possibly take the position that for some reason known only to the inexperienced NYSE staff, CAP-DI orders, alone among all order types, are offered some unique treatment in this regard (and if it did take that position, it would need an SEC approval order). In introducing Direct, while also emphasising the continued applicability of the order exposure/price improvement rules, the NYSE obviously made a policy decision (implicitly endorsed by the SEC in approving Direct) to live with occasional anomalous results as the inevitable consequence of overlaying an automatic execution facility on top of a traditional physical auction. One can argue with the merits or demerits of this, but one cannot argue with the fact that the rules are what they are, and must be followed until amended.

4. It is no secret that Direct is hated by specialists and floor brokers alike for the ways in which it disrupts the physical auction, but the NYSE has consistently taken the position that specialists, in the event, do not "miss the market" when they expose any order type to the auction and Direct takes the contra side liquidity before an execution can be completed. NYSE jargon, I'm told by floor brokers, calls this "stock ahead", and is analgous to the way a floor broker can similarly take contra side liquidity when a specialist exposes an order. (My institutional clients tell me they often complain to the NYSE when floor brokers do exactly this, but they are always told that the specialist did not miss the market because of "stock ahead", which is the inevitable consequence of how the auction works. If the SEC staff is any doubt about this, they should review whatever records the NYSE keeps of its "Institutional Helpline").

5. The NYSE's "clarification" did not respond at all to a critical point I made: the NYSE speaks of "systematizing" orders that are currently handled manually, but is entirely silent on the central issue as to how exactly the specialist "manually" executes the order. The only rules the NYSE has in this regard are Rules 76 and 91, which apply unambiguously to every single order represented by the specialist, without exception.There is simply no NYSE rule that allows the specialist to simply assign a price to any order without exposing that order to a trading crowd.

6. While the NYSE is correct that the definition in Rule 13 speaks of an elected CAP-DI order being executed at the price of the electing transaction, this language cannot possibly be read as precluding an improved price as well. It has been implicit in the NYSE's overall regulatory framework for the last 200 some odd years that every order on the NYSE is eligible for price improvement, and is made explicit in the universal applicability of the basic definitions of market and limit orders and the order exposure/price improvement methodology of Rules 76/91. The reference to a CAP-DI order's being executed at the price of the electing transaction, and its being cancelled if not so executed, is obviously intended simply to tell the specialist to cancel the election if there is no contra side liquidity at the electing price, and cannot be read as precluding the specialist from executing the order at a better price if then immediately obtainable, as there would be no possible public benefit/rationale whatsover in such an "interpretation."

Obviously, the points I made about "electronic representation" of floor broker orders with respect to the execution of elected stop orders are equally applicable to elected CAP-DI orders.

I ask that my entire discussion of CAP-DI orders contained in my letter of September 22, 2005 be incorporated by reference herein.

Sincerely yours,

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