August 3, 2006

Dear SEC:

On June 22, 2006, I submitted a comment letter on the first iteration of the above-referenced rule submission. The NYSE subsequently submitted Amendment 1, which replaced in its entirety the first submission. As Amendment 1 is essentially a tightening up of a few technical details, my June 22 letter obviously continues to be directly material to this proposal.

I would also like to address two other issues raised by this matter.

Item 5 of Form 19b-4 and the Commission's Public Comment Process

Item 5 of SEC Form 19b-4 (the legal document embodying SRO rule submissions) requires an SRO to make a statement about public comments it receives. As I have always understood it, the purpose of this requirement is to ensure that an SRO fully discloses all issues that have been raised, and the SRO's views thereon, when the matter is formally published in the Federal Register, with the accompanying solicitation of public comments. This requirement aids the public comment process by highlighting issues for potential commentators.

In Amendment 1, Item 5 of Form 19b-4, the NYSE noted that it had received one (unidentified by the NYSE) comment (presumably mine). Rather than comply with the SEC's clear requirement to discuss the issues raised, the NYSE simply stated that it would comment at the end of the official public comment period following publication of the matter in the Federal Register.

How did the SEC staff allow the NYSE to disregard the Commission's clear requirement here? Potential commentators are thus denied the opportunity to consider, as reflected in the Federal Register notice itself, highly material comments unless they know about the comment and how to track the matter down on the SEC's website, which is not that easy to do, and which, under the SEC's own requirement, is no substitute for a fleshed-out Federal Register discussion.

If the SEC's requirements do not mean what they say, or if they are not going to be enforced, the SEC should abandon them. What the NYSE was allowed to get away with in this instance can only undermine public confidence in the integrity of the Commission's rule approval process.

There is, however, a larger issue. As my March 27, 2006 (SR-NYSE-2004-05) and August 2, 2006 (SR-NYSE-2005-38) letters demonstrate in detail, the SEC's public comment process is breaking down, particularly with respect to the NYSE's proposals. The "hybrid" market proposal, in particular, suggests an unsavoury spectacle in which the NYSE is holding a gun, with two bullets in the chamber, aimed squarely at the SEC's head.

The first bullet is Regulation NMS, as to which the NYSE, a premier primary market, must surely make readiness adjustments. But nothing in Regulation NMS can be read to suggest that the NYSE needs to grant its

trading floor intermediaries the unprecedented, anti-competitive trading privileges vis-a-vis the public limit order book that the NYSE has proposed. In fact, as I have repeatedly pointed out, the underlying philosophy of Regulation NMS cuts in exactly the opposite direction. (See additionally, the June issue of Traders Magazine, in which buyside personnel are quoted as saying that the NYSE "hybrid" market is no place to send public limit orders to be posted on the public limit order book. This is a terrible commentary on a primary market).

The NYSE is simply using Regulation NMS as "cover" for enhancing the privileges of trading floor intermediaries. And the SEC staff have lacked the fortitude to call a spade a spade here.

The second bullet is the NYSE's aggressive programming of its systems in contemplation of SEC approval of its trading floor-enhancing proposals. The NYSE simply tells the SEC staff, "Look, we've spent all this money, you have to approve it", and the SEC staff feel pressured to cave in.

Am I being unduly harsh here? Consider the SEC staff's treatment of public comments and the NYSE's "responses." In both SR-NYSE-2004-05 ("hybrid" market) and SR-NYSE-2005-38 (a whopping 40 percent cut in specialist capital requirements), the SEC staff purported to "summarise" public comments, but made material omissions when certain public comments directly called into question any of the SEC's pre-determined "realpolitik" conclusions. The SEC staff's rule-of-thumb (borrowed from the NYSE) appears to be that when a public comment is too tough to deal with, simply pretend that it doesn't exist.

The NYSE, however, is given carte blanche. In "responding" to public comments, it typically "cherry-picks" only a handful, and its "responses" are little more than reiterations of its original positions. As I have pointed out in specific detail, the NYSE often ignores altogether the most serious criticisms.

The SEC staff seem content to treat anything calling itself a "response" as sufficient, regardless of whether the NYSE has in fact responded to all substantive criticisms, and regardless of whether the NYSE's "responses" in fact join issue with the material substance of the criticisms. Thus, the SEC staff make blithe assertions that the NYSE has "responded" to criticisms, when no fair-minded reading of the correspondence could possibly support such a conclusion. (I demonstrated this in detail in my March
27 and August 2 letters referenced above).

An even greater problem is the abject failure of the SEC staff to actually analyse public comments, and weigh the substance of those criticisms against the substance of what the NYSE has proposed. At best, the SEC merely "summarise" (with material omissions) the public comments, "summarise" the NYSE's "responses"
(while never mentioning the NYSE's material omissions), and then uncritically accept the NYSE's positions.

This nonsense needs to stop. The Commission has a choice to make: clean up the SEC staff's act or abandon a process that is degenerating into farce.

The instant proposal raises very serious issues indeed, issues the Commission refused to deal with in the "hybrid" market approval order, and issues that clearly raise significant issues of legality under Section 11A and other provisions of the Securities Exchange Act, to say nothing of the many fundamental inconsistencies with Regulation NMS.

The SEC staff need to start working a whole lot harder here in asserting the public interest, and not giving in on every major issue to the NYSE's trading floor intermediaries.

## The Specialist's Affirmative and Negative Obligations

In my extensive comments on SR-NYSE-2004-05 (the basic "hybrid" market proposal), I have repeatedly emphasised how the NYSE's proposal is positively opaque with respect to the affirmative obligation, and, in its radical, anti-competitive expansion of specialist dealer trading opportunities, is fundamentally inconsistent with the specialist's negative obligation.

The Commission's posture on these issues is inexplicable. And these are not obscure legal technicalities, but major regulations reflected quite clearly in Section 11(b) of the Securities Exchange Act, SEC Rule 11b-1, and the NYSE's most important dealer rule, Rule 104.

One would have thought that both the NYSE and SEC staff would have wrestled with these regulations in the first instance, as they are the very legal foundation for any specialist dealer trading. How could the SEC possibly have approved the NYSE's dealer trading proposals without demanding appropriate rule amendments? And this is hardly easy stuff, because both Section 11(b) and Rule 11b-1 are implicated, not just Rule 104.

Instead, the public has been treated to classic "cart before the horse" rulemaking, as exemplified by the absurdity of footnote 382 in the "hybrid" market approval order. This footnote reflected a telephone conversation between the NYSE and SEC staffs to the effect that the NYSE would be required to provide "guidance" to specialists as to how any of the expanded dealer trading activity could possibly be legal under the negative obligation. (Hint: it isn't legal absent substantial rule amendments, the approval of which cannot be presumed). And this telephone conversation took place on the very day that the "hybrid" market approval order was issued! QED, loaded gun theory!

However belatedly (I have emphasised this issue time andagainover the past yearand a half), the NYSE seems to be waking up to the matter. The July 2006 issue of Traders Magazine (which has done an excellent job of covering "hybrid" issues, particularly the pieces by Gregory Bresiger)notes that the NYSE has acknowledged that implementation of the "hybrid" market would mean the "NYSE must re-consider specialist affirmative and negative obligations under Rule 104." In the same issue, Richard Ketchum, head of NYSE Regulation, is quoted as saying, "We may have to redefine the negative obligation." (Hint: any such "re-consideration" or "redefinition" must of necessity also take into account Section 11(b) and Rule 11b-1, and there must be formal amendments and extensive public comment, because this is a "rubber

meets the road" issue for public investors, who need to have input as to what a specialist ought to be able to do, and ought not be able to do, in competing directly with their orders. This obviously goes way beyond "guidance").

The haste and sheer absurdity reflected in footnote 382 are indicative of the SEC's "approval today, legality tomorrow (maybe)" approach to the "hybrid" market. How could the Commission possibly have approved expanded dealer trading without first and foremost determining whether and how such trading could ever be reconciled with existing law and rules that run in exactly the opposite direction?

This is a mess: the SEC has approved a form of trading that is nonetheless illegal, as the NYSE's admission that it needs to "redefine" (translation: amend) the negative obligation clearly indicates. And if the Commission allows the NYSE to sweep this under the rug with an "interpretation" that evades the formal rulemaking/prior public comment process, there are sure to be lawsuits aplenty,because direct specialist competition with public orders is about as big-time as issues get.

The instant proposal, by allowing specialists to compete directly with floor broker public orders, certainly flies in the face of the negative obligation. It is clearly time (way overdue, in fact)for the SEC staff to finally start putting the horse before the cart here. The NYSE needs to first propose for public comment a suitable amendment to Rule 104, and the Commission needs to assess the Section 11(b) and Rule 11b-1 implications. Only after this process has been completed, and a legal foundation clearly established and known to all, should the Commission begin to assess the NYSE's specialist "algorithm" and "parity" trading proposals in the light of revised dealer trading rules.

The Commission, to date, has gotten it exactly backwards.

Sincerely yours,

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