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Via email to rule-comments@sec.gov

September 13, 2006

Nancy M. Morris, Esq.
Secretary
Securities and Exchange Commission
Station Place
100 F Street, NE
Washington, D.C. 20549-9303

Re: SR-NYSE-2006-36 (NYSE d-Quotes℠) and Amendment Nos. 1 and 2 thereto.

Dear Ms. Morris:

The New York Stock Exchange (the "Exchange" or "NYSE") is writing to respond to four letters (4) letters[1] submitted in response to the Securities and Exchange Commission's (the "Commission" or "SEC") solicitation of comments in connection with the NYSE d-Quote℠ ("d-Quote") filing and Amendment Nos. 1 and 2 thereto.[2]

Many of the comments raised in the letters relate to rule changes covered in other NYSE filings, including SR-NYSE-2004-05 (NYSE HYBRID MARKET℠ filings; the "Hybrid Market")[3] and SR-NYSE-2005-38 (Specialist Organization Capital Requirements),[4]

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1 See George Rutherfurd, Consultant, dated June 22, 2006 ("Rutherfurd Letter I"); George Rutherfurd, Consultant, dated August 3, 2006 ("Rutherfurd Letter II"), Independent Broker Action Committee, Inc. by Warren P. Meyers, President, dated August 10, 2006 ("IBAC Letter") and Junius W. Peake, Monfort Distinguished Professor of Finance, Kenneth W. Monfort College of Business University of Northern Colorado, dated August 18, 2006 ("Peake Letter").

2 See SR-NYSE-2006-36 (May 16, 2006), corresponding Amendment No. 1 (June 14, 2006) and corresponding Amendment No. 2 (July 11, 2006).

3 See Securities Exchange Act Release No. 53539 (March 22, 2006), 71 FR 16353 (March 31, 2006) (SR-NYSE-2004-05).

4 See Securities Exchange Act Release No. 34-54195 (7/24/06), 71 FR 43260 (7/31/06).

which have already been approved by the SEC. Other comments focus on non-substantive issues, such as terms used to describe some of the functions covered by the filing, rather than the way such functions operate. Accordingly, this letter responds only to substantive comments on SR-NYSE-2006-36.

Background

The "Floor Broker's Agency Interest File," which is referred to as an "e-Quote" (See Exchange Rule 70.20), was approved by the Commission in March 2006 as part of the Hybrid Market filings. This rule forms the foundation of the d-Quote proposal, which provides for discretionary instructions to be added to the e-Quote.[5] This allows Floor brokers to perform a similar role with respect to the electronic representation of their customers' orders as they do in manually handling orders in the Crowd today. The proposed discretionary features, including a pegging function, facilitate the ability of orders handled by Floor brokers to participate in and initiate automatic executions that they would not, with current e-Quoting capabilities, be able to do. As described in more detail below, the d-Quote allows the Floor broker in the Crowd to better compete with the specialist and other Floor brokers that, in turn, provides more opportunity for better-priced executions and provides balance and fairness to the Hybrid Market.

All of the trading tools and processes provided for in the Hybrid Market, including the Floor broker's e-Quote and d-Quote, will produce more execution choices than exist in any other equities market today. Customers who want execution speed and certainty, with anonymity, can opt to have their orders automatically executed via NYSE Direct+® ("Direct +"), the Exchange's electronic trading facility. Customers who want the opportunity for price improvement or the benefit of Floor broker expertise in the handling of their orders can choose to utilize the traditional benefits of the manual auction process enabled for a more electronic market.

Interaction between Floor brokers and specialists continues to be a catalyst to trading, and both functions are integral to the success of the Hybrid Market. Floor brokers will continue to perform their vital functions through the use of the Floor broker agency interest files (or e-Quotes) and d-Quotes. Specialists will continue to perform their vital functions by layering proprietary interest, and algorithmically interacting with orders.

1. Comments Questioning Whether d-Quotes Assist in Replicating the Floor Broker's Traditional Role

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5 The term "discretionary" refers to the ability of the Floor broker entering the d-Quote to determine how the order appropriately should be handled in accordance with the customers' instructions. Cf. Peake Letter, pg. 2. See also Rutherfurd Letter I at pg. 5.

While a commenter suggested that d-Quoting does not replicate the Floor broker's traditional role in the auction market,[6] in fact, d-Quotes are necessary to ensure that Floor brokers are able to perform a function similar to that which they perform today as the market becomes faster and more automated, with the same flexibility in representing their customers' orders.

The functionality of the d-Quote allows customers to reap the benefits of Floor broker knowledge and trading experience, yet not be excluded from the opportunity to participate in automatic executions. As designed, it is intended to replicate, as far as possible, how Floor brokers traditionally operate. Thus, the Floor broker must be in the Crowd to enter d-Quotes. In this way, the continuation of the price discovery process is assured. The use of discretionary instructions allows the Floor broker to electronically replicate the order management decisions he or she makes regarding the representation of customer orders. Without d-Quoting ability, customers opting to use Floor brokers would not be able to access the market in the same ways as they can today. The d-Quote enables Floor brokers to electronically represent agency interest at various prices at or within the Exchange quote by utilizing price discretion and pegging. This is similar to how Floor brokers handle their customers' orders in the Crowd today. In this way, Floor brokers are able to employ the full extent of their judgment and expertise in managing their customers' orders within a faster, more automated market.

2. Comments Concerning d-Quote Transparency and Whether d-Quotes Provide Informational Advantages

Some comments suggested that d-Quotes are "hidden" orders and therefore not transparent and that this negatively impacts price discovery and provides informational advantages.[7] In this regard, the comment focused both on the d-Quote's ability to automatically trade between the quote and the functionality of reserve interest.[8]

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6 See Rutherfurd Letter I at pg. 1, et seq.

7 See Rutherford Letter I at pg. 1, et seq.

8 The ability of Floor brokers to maintain reserve interest was approved by the Commission as part of the Hybrid Market filings and this proposal introduces no changes to the reserve functionality already approved. Accordingly, this Response will not focus on issues related to reserve interest, other than to point out that the existence of reserve interest is not unique to the Exchange and is consistent with that available in other markets. Indeed, all electronic order books have reserve functionality at all price levels, not just at the BBO, see, e.g., Securities Exchange Act Release No. 46410 (August 23, 2002), 67 FR 55897 (August 30, 2002) (NASDAQ SuperMontage Filing).

It is important to note that the function of d-Quotes is consistent with other market centers that permit non-displayed orders that trade between the quote. Generally, these rules have been approved in response to the preference of market participants for order and customer anonymity, despite the typical argument that such anonymity is detrimental to other market participants. Indeed the commenter recognizes this, by noting, "…many traders want to hide their own orders, while demanding that everyone else show theirs…"[9]

Notwithstanding the repetition of this argument in connection with the Exchange's proposal, d-Quotes essentially replicate that which occurs in the manual auction market and do not provide any more <u>or any less</u> information than was previously available in the Exchange market. The d-Quote is as transparent as any other Floor broker-represented order that is not fully displayed in accordance with long established trading practices, SEC rules and regulations and NYSE rules and regulations.

Further, the commenter, who recognizes that the Exchange is the "world's premier price discovery venue,"[10] questions whether d-Quotes will impact this price discovery mechanism. The laudable price discovery process is a function of the Exchange's market structure that involves Floor brokers representing customer orders, limit orders on the Display Book®[11] and the specialist's dealer interest. Their interaction, which continues in the Hybrid Market, ensures that the price discovery mechanism will exist. Discretionary instructions for e-Quotes merely enhance the ability of Floor brokers to effectively represent their customers' orders in the automated portion of the Hybrid Market. They are not a substitute for this interaction and the resultant price discovery.

Similarly, rather than creating price uncertainty,[12] d-Quotes provide a better opportunity for price improvement and moderate volatility by providing liquidity and better price continuity. For these reasons, the existence of the d-Quote functionality will attract liquidity, as incoming orders will seek the opportunity of a better priced and/or larger-

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[9] <u>See</u> Rutherfurd Letter I at pg. 3.

[10] Ibid.

[11] The Display Book® ("Display Book" or "book") is an order management and execution facility that receives and displays orders to the specialist and provides a mechanism to execute and report transactions and publish the results to the Consolidated Tape. In addition, the Display Book is connected to a variety of other Exchange systems for the purposes of comparison, surveillance, and reporting information to customers and other market data and national market systems (i.e. the Intermarket Trading System, Consolidated Tape Association, Consolidated Quotation System, etc.).

[12] <u>See</u> Rutherfurd Letter I at pg. 3.

sized transaction that may result as a consequence of the increased competition with specialists and other Floor brokers that d-Quotes provide.

One commenter suggests that the existence of d-Quotes creates an "'unlevel' informational playing field."[13]

While the d-Quote may provide Floor brokers' customers with the benefits of discretionary instructions, the d-Quote does not create an unequal or unfair advantage for any market participant.

The specialists' systems that enable algorithmic trading will not be privy to any discretionary instruction information regarding d-Quotes. Further, neither the specialist on the Floor nor the specialist algorithmic trading system will have access to any of the discretionary instructions entered by the Floor broker in connection with the d-Quote. The specialist will not know the size of any particular customer's reserve interest. Only the specialist on the Floor will have access to limited information pertaining to interest in the files. The specialist will not know the number of customer orders behind such volume, who the orders are for, which brokers represent the orders, the limit prices for such orders, or the d-Quote instructions applicable to them. Specialists will be able to view only total aggregated broker agency interest at each price.

Similarly, Floor brokers will have access only to information pertaining to their own agency interest. They will not have access to other broker's files. All d-Quotes do is permit each Floor broker to make the same type of decisions he or she makes in the Crowd today, which is not necessarily transparent to other market participants at the time they are made, and express those decisions in such a way that their customers do not miss opportunities to trade in a faster, more automated environment. Buyers and sellers will continue to have an opportunity to interact and make pricing decisions based on that interaction.

Lastly, there is no merit to the suggestion that limit orders on the Display Book will have less access to information as a result of d-Quotes. Those entering limit orders will be privy to the same information as is available to them today, which does not include knowledge of a Floor broker's decisions regarding order management until after such decisions are effected.

3. Comments Questioning Whether d-Quotes are Compliant with Regulation NMS

Comments were received questioning whether d-Quotes will violate the Order Protection Rule of Regulation NMS.[14] All of the Hybrid Market filings, including the proposed d-

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13 See Rutherfurd Letter I at pg. 1, et seq.; See Peake Letter at pg. 2.

Quote filing, have emphasized that these new initiatives will operate in full conformity with all SEC rules, including Regulation NMS. Clearly the Exchange cannot operate otherwise. Indeed, the d-Quote filing specifically provides that d-Quotes will operate in compliance with Regulation NMS, including the Order Protection Rule ("OPR")[15] (See proposed Rule 70.25 (d)(vi)(A)(1)-(2) and (d)(vii)). Orders, or parts thereof, represented via d-Quotes will be routed away to other market centers, as OPR requires. As such, d-Quotes clearly fulfill the order protection objective of Regulation NMS – that executions do not occur at prices inferior to those displayed at the "top of the book" by other market centers at which automatic executions are available. If a d-Quote's price discretion is used to initiate a trade on the Exchange, and such price is not equal to the national best bid and offer ("NBBO"), the d-Quoted order (or relevant part thereof) will be automatically routed to such other market centers as necessary.

4. Comments Questioning Whether d-Quotes Disadvantage Limit Orders on the Display Book or Other Market Participants

Some comments questioned whether d-Quotes disadvantaged limit orders on the Display Book by "denying executions to those who post liquidity."[16] However, contrary to this assertion, the principles of priority and parity at the NYSE best bid and offer ("BBO") have not changed with the introduction of the d-Quote. Thus, a limit order with priority at the BBO on the same side as the d-Quote will trade first in any execution at the quote. Similarly, the d-Quote does not force or cause limit orders to accept different or worse prices than what their limits dictate.

Discretionary pricing, a component of the d-Quote that replicates the Floor broker's judgment today, allows d-Quotes to trade at prices in between the quote - where there are no public limit orders. In doing so, the d-Quote provides price improvement to an incoming order capable of trading at such price and does not negatively affect the limit order displayed at a worse price. In this way, d-Quotes perform a beneficial service, providing significant pricing competition to specialists and other Floor brokers. All market participants will benefit, as more competition will attract greater liquidity and hence, result in better executions.

What the commenter seems to be suggesting is that had the person entering the limit order known there were other market participants interested in trading at that better price, they too may have entered their limit order at that price. Nevertheless, the fact remains that nothing prevented the limit order from being entered at such better price. Further,

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14 See Securities Exchange Act Release No. 51808 (June 9, 2005), 17 CFR 200, 201, 230, 240, 242, 249, and 270.

15 See Section 242.611 of Regulation NMS.

16 See Rutherfurd Letter I at pg. 3, et seq.

nothing in the securities laws or Exchange rules require that every market participant fully disclose their interest at the best price possible. Rather, customers are permitted to choose from a variety of options for their orders, including the order management provided by Floor brokers.

Lastly, d-Quotes enable Floor brokers to effectively compete with other participants in a more automated market place. This is recognized by one commenter who states "The… 'd-Quote'…goes a long way towards recreating market balance in the hybrid environment."[17] The d-Quote is an effective trading tool that allows the Floor broker to interact with other Floor broker orders and the specialist's algorithmic trading system and, by doing so, enables the Floor broker to obtain and sustain a highly competitive position in the Hybrid Market. Competition in the market place is beneficial to all. To the extent that d-Quotes add more competition in the Hybrid Market, they should be encouraged and embraced.

5. Comments Concerning d-Quotes and Sweeps

One commenter suggested that the d-Quote rule is weakened by Amendment No. 1, which merely clarified that discretionary instructions are not active in sweeps initiated by other orders.[18]

The proposed rule provides that d-Quotes may initiate sweeps, but only to the extent of their price and volume discretion. Additionally, the proposed rule provides that d-Quotes may participate in sweeps initiated by other orders, but their discretionary instructions will not be active.[19] This recognizes that when a d-Quote is participating in a sweep (as opposed to initiating a sweep) employing its discretionary pricing instruction does not provide additional value to the customer order being d-Quoted.

6. Comments Concerning the Implementation Schedule for d-Quotes

One commenter suggests that the d-Quote should be phased into the Hybrid Market at the same time as the specialist's ability to algorithmically quote and trade based on order information – not after.[20]

Given the complexity of the software developed for the d-Quote functionality and the extensive system changes required to enable increased automatic execution capabilities,

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[17] See IBAC Letter at pg. 1.

[18] See IBAC Letter at pg. 2.

[19] See Proposed Rule 70.25(d)(ix).

[20] See IBAC Letter at pg. 2.

the Exchange is not able to launch all of these initiatives at the same time despite the Exchange's best efforts. Floor brokers requested the d-Quoting functionality well after the design of e-Quoting was completed and the necessary programming changes were scheduled. As a result, d-Quoting was initially slated for implementation as part of the last phase of Hybrid. However, in response to requests from Floor brokers, the Exchange made every effort to move d-Quote implementation forward as much as possible. In addition, the Exchange agreed to add to the upcoming software releases a number of other changes recently requested by Floor brokers, designed to improve the efficiency of the devices they use to access the market. Lastly, the rollout of d-Quotes is timed to a program that provides ample training and trading practice for Floor brokers using the new functionality. Accordingly, the sheer volume of system and other required software changes, coupled with the need for appropriate training, mandates that the Exchange implement d-Quoting in two parts.

The first part, which would be implemented as part of Phase 3 of the Hybrid Market, provides pegging and d-Quote functionality with respect to the ability to trade with marketable orders. The second part, which provides d-Quote functionality with opposite-side interest anywhere in its discretionary range, is scheduled for implementation in Phase 4 of Hybrid. Phase 3 is currently scheduled to commence on or about October 6 and is expected to be completed in early-December 2006. Phase 4 is expected to begin in December 2006, immediately following the completion of Phase 3. Further, the Phase 3 roll-out is expected to begin slowly, with the bulk of it coming on line in the late Fall. Accordingly, there will be little delay between the implementation of full d-Quoting ability in the bulk of securities.

Moreover, under the phase-in plan, Floor brokers are on equal footing with specialists regarding their ability to trade by price improving marketable incoming orders. Floor brokers and specialists will both be able to do this electronically in Phase 3 – Floor brokers via d-Quotes and specialists via their algorithmic systems. Additionally, Floor brokers' ability to price improve is unrestricted. Further, while Floor brokers will not be able to use d-Quotes to interact with non-marketable incoming orders (i.e., orders that would set a new NYSE BBO) via d-Quoting until Phase 4, they will be able to manually interact with them in Phase 3. Moreover, specialist algorithmic messages to trade with the NYSE quote ("hit bid/take offers"), which will be available to them in Phase 3, are systemically delayed to ensure that the new BBO is published, whereas Floor brokers have the ability to manually "hit the bid" or "take the offer" without any system-imposed delay.

For these reasons, the Exchange believes that the phase-in process is sensitive to the varied needs of all market participants affected by the introduction of these complex changes. Additionally, thorough and proper broker training and preparation for the d-Quote is essential, as it protects the broker from making unintended trading errors, which could result in taking out the quote and unintended sweeps, among other things.

Lastly, a comment in the same letter discusses "ongoing difficulties with time and reliability of the d-Quote mechanisms now being tested." The Exchange is unsure of the meaning of this comment, as no such testing had begun as of the date of the letter, which is August 10, 2006.[21] Testing of that sort only began after the date of the letter, and such testing was internal to the Exchange.

7. Comments Questioning Specialist Ability to Trade on Parity with a d-Quote

One commenter took issue with the proposed rules in that they do not permit the Crowd to electronically prevent the specialist from trading on parity with a d-Quote, or indeed, any e-Quote[22] (See Exchange Rule 70.20). The provision regarding e-Quoting was approved as part of the Hybrid Market filings, and the d-Quote rule makes no changes to that provision. Rather it merely re-iterates this fact in the context of an e-Quote to which discretionary instructions apply. Floor brokers continue to retain the right to exclude specialists from parity with respect to manual transactions. To the extent Floor brokers want to prevent specialists from trading on parity with their orders in the Hybrid Market, they retain the right to send those orders for execution through SuperDot®. Indeed, this solution was supported by Floor brokers who worked with the Exchange in designing the e-Quoting functionality.

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If you have any questions regarding the foregoing, please feel free to contact Nancy Reich, Vice President, Office of the General Counsel, at (212) 656-2475, Deanna Logan, Director, Rule Development, Office of the General Counsel, at (212) 656-2389, or Jean Walsh, Principal Rule Counsel, Office of the General Counsel at (212) 656-4931.

Sincerely yours,

Mary Yeager

[21] See IBAC Letter at pg. 2.

[22] Ibid.