September 10, 2006

Dear SEC:

I am submitting comments with respect to the above-referenced matter prior to its being published in the Federal Register because of the Commission's alarming tendency to grant immediate or accelerated effectiveness (no prior public comment, only a relatively meaningless "after the fact" comment period) with respect to NYSE "hybrid" market rule submissions that raise serious, substantive issues. (The Commission's granting of accelerated effectiveness to Amendments 6 and 8 to SR-NYSE-2004-05, which the NYSE itself had not even sought in its submissions, is only the most egregious example).

While the NYSE has characterised the instant submission as simply involving redefinitions and clarifications, the submission is, in fact, highly substantive. As discussed below, the NYSE's proposal raises serious issues which have been the subject of extensive public criticism. Yet, the SEC staff allow to NYSE to (mis)represent in Item 5 of Form 19b-4 that it has received no comments on the instant proposal, a disingenuous statement if ever there were one. The NYSE is clearly aware of the issues raised, but the SEC staff simply will not enforce the Commission's requirement that the NYSE discuss those issues.

I ask that my June 23, 2006 and August 11, 2006 comment letters on SR-NYSE-2006-36, and my November 8, 2005 comment letter on SR-NYSE-2004-05, be incorporated by reference herein, as the issues raised in that correspondence bear on the instant rule submission as well.

The Death of the Physical Auction

The instant rule submission makes clear that, for all intents and purposes, the physical auction has faded into history. While the NYSE may maintain its physical trading floor (at least in the very near term), it has clearly abandoned the regulatory framework under which orders received the benefits of auction market trading. In practical effect, the specialist is to be neither the "agent" nor the "executing broker" for the types of orders historically represented by the specialist. These roles are to be assumed by an NYSE computer, with no specialist intermediation other than by predatory, monopolistic algorithm. Floor brokers are reduced to little more than electronic order entry clerks, as physical order representation is a gold-plated invitation to "miss the market." The NYSE's virtual rescission of Rule 76, its critical auction market order exposure/price improvement rule, is simply the final nail in the coffin.

Given the speed and efficiency of electronic trading, one would like to be able to say, without reservation, that the abandonment of physical auction trading is a positive development. But one is constrained by three considerations.

First, the NYSE disingenuously maintains that customers can nonetheless continue to receive the benefits of auction market trading (see, e.g., the NYSE's September 21, 2005 comment letter on SR-NYSE-2004-05), even as it rescinds or "redefines" out of existence the very rules that provided such benefits.

Second, the NYSE disingenuously maintains that it is simply "replicating" the physical auction, even as it seeks to introduce a radical new way of trading very much at odds with physical auction trading.

Third, and most to the point, the NYSE's proposed methodology for electronic trading confers unprecedented, unconscionable, and anti-competitive advantages on its trading floor intermediaries, to the absolute detriment of the public limit order book, and in direct conflict with clearly applicable law. (See the correspondence incorporated by reference).

As my June 23, 2006 comment letter pointed out in specific detail, the NYSE has clearly not "replicated" its physical auction, but rather has succeeded in "replicating" only the least desirable aspect of the physical auction (the time/place advantage accruing to floor traders by virtue of their presence on the trading floor), with none of the ameliorating factors present in the physical auction that minimise the time/place advantage.

Below, I discuss two aspects of the instant rule submission: the treatment of "elected" stop orders, and the "revised" sweep methodology. Both of these matters raise serious, rubber-meets-the-road legal issues which to date the SEC has been disinclined to address. It is essential and absolutely in the public interest that the SEC staff properly and analytically engage these matters rather than, as they have been doing, simply accepting at face value the NYSE's self-serving assertions, notwithstanding extensive public criticism debunking the NYSE's positions.

The Treatment of "Elected" Stop Orders

In the instant rule submission, the NYSE is proposing to "hide" information about unelected stop orders from the specialist (and everyone else, for that matter).
In the NYSE's view, this will obviate the necessity for the specialist to "guarantee" elected stop orders the electing sale price when the specialist has been party to a transaction that "elects" the stop orders.

On one level, there is a certain plausibility to the proposal. Under current rules, the specialist does have information about elected stop orders, and, absent the guarantee requirement, could be party to a transaction that elects the orders, and could then buy from or sell to the orders at a premium or discount from the electing sale price. Thus, the "guarantee" requirement minimises the inherent conflict of interest here. (The conflict of interest is not entirely eliminated, as the specialist may wish to trigger the "election" to have an opportunity to buy or sell at the electing price). In the NYSE's view, there would be no reason to have the "guarantee" requirement if the specialist has no knowledge of the unelected stop orders in the first place. The stop orders, when elected into market orders, would simply be excuted in the same manner as any other market order entering the market.

What the NYSE is proposing, however, while arguably addressing the conflict of interest problem, in fact exacerbates another problem, the "license" being given to specialists to have exclusive trading privileges, in the first instance, to trade with market orders. Under the NYSE proposal, information about elected market orders is sent simultaneously to the display book and to the specialist's algorithm, pre-programmed and embedded in NYSE trading systems.
Information about market orders is not "published" in the NYSE's quotation, which means the specialist's algorithm gets the absolute first crack at trading with the elected stop orders. (This problem arises with all stop order elections, not simply those that are the immediate subject of the NYSE's proposal).

The bizarrely misnamed floor broker "e-quotes" and "d-quotes" play second fiddle to the algorithm (they only get to trade if "hit", and cannot intercept market orders as the specialist's algorithm can), and the real, off-floor trading community is a distant third, notwithstanding that these are entirely electronic, intermediary-less executions.

In my "hybrid" correspondence, I have repeatedly emphasised that specialist algorithmic trading as proposed by the NYSE is clearly inconsistent with both the affirmative and negative obligations. Both the NYSE and the SEC staff appear to take the position that these fundamental pillars of specialist regulation, dating back to the 1930s as a matter of federal law and SEC and NYSE rules, are mere nagging administrative inconveniences, to be "interpreted" to fit current fashion. The SEC staff's abject failure to analyse these issues and demand either that the NYSE conform to these requirements, or propose appropriate amendments to this very clear-cut regulatory framework, borders on dereliction of duty.

The instant proposal clearly brings the affirmative and negative obligations to the fore. One benefit of the "guarantee" is that it minimises price dislocation that can result from an influx of elected stop orders into the market. Absent the guarantee, the specialist's algorithm may trade at a distance from the last sale that would be absolutely precluded under current rules, adding to overall market volatility, while allowing the specialist to buy/sell at a tidy premium/discount. Doubtless, when confronted with such a criticism, the NYSE will simply provide their intelligence-insulting, all purpose answer, "Not to worry, we will surveil this." (One lives in hope they will "surveil" this, it is their legally-mandated job, but this is hardly the issue). What the NYSE really needs to do, however, is discuss this aspect of their proposal under the affirmative obligation, and provide clear, hard-edged standards, known in advance to all market participants, who can then make order entry decisions based on their assessment of the likely impact of specialist trading on their orders. Simple, fundamental fairness requires no less, to say nothing of the legal requirements of the affirmative obligation itself. The SEC staff simply cannot continue to allow the NYSE to to get away with its pro forma, formulaic pabulum about surveillance. The SEC staff must take cognisance of the fact that the professional trading community demands much more from the SEC in this regard, particularly in the wake of two recent SEC enforcement actions against the NYSE for failure to surveil its rules adequately. Public perception is a critical factor here.

As troubling as the NYSE proposal is under the affirmative obligation, even more serious problems arise under the negative obligation. Under applicable law and rules, specialists may trade only when necessary to maintain a fair and orderly market. As I have discussed in specific detail in prior correspondence, the regulatory framework permits the specialist to function as a monopolistic dealer in the primary market, but subject to the significant constraint that the specialist may act as dealer only as the "trader of last resort." In the current auction, the specialist may trade with elected stop orders only after they have been exposed to the market, and only if no other market participant will trade with them. In the proposed "hybrid" market, the orders are exposed to no one, and the specialist's algorithm (which will be programmed to ensure maximum specialist profitability)gets first crack at trading, and can entirely shut the public out.

The NYSE proposal (in this regard, as well as with algorithmic interception of orders generally) is in direct conflict with very clear law and rules, which manifestly are intended to limit specialist dealer activity, and provide maximum opportunities for public order interaction. Other than its sporadic, irrelevant pabulum about "surveillance", the NYSE cannot even be bothered to acknowledge the negative obligation. But what is even more shocking is the SEC staff's failure to assert the public interest here, and, absent appropriate amendment, demand that the negative obligation be observed.

Far from "replicating the physical auction, the NYSE proposal represents a radical departure from the current regulatory framework, both in overall philosophy and in specific implementing details. As discussed in the correspondence incorporated by reference, the SEC, before addressing the NYSE's dealer-centric algorithmic proposals, needs to step back and focus on the over-arching regulatory framework here. The issue is simple: To what extent, and how, should a monopolistic dealer in a primary market be given the exclusive privilege to trade with incoming orders? (As my June 23, 2006 letter demonstrated, the NYSE's "d-quote" proposal hardly solves the problem).

This cannot be a matter of "interpretation", as the NYSE's proposals are inherently inconsistent with existing law and rules. (The NYSE has literally stood the negative obligation on its head).

The SEC staff need to stop being steamrollered by the NYSE on this isue. The preferable course of action is for the SEC simply to require that the NYSE conform to the negative obligation and provide a method for all market participants to engage in algorithmic trading, with the specialist's algorithm being permitted to trade only when there is no public interest in doing so. This would "replicate" the existing approach to specialist dealer trading, and would conform to the current regulatory framework.

If the SEC staff lack the intestinal fortitude to demand that the law be followed, they must insist, a priori, that the NYSE submit appropriate amendments to the existing regulatory framework. (This is not all that simple, as it involves federal law and rules as well as NYSE rules).

The SEC staff should then hold in abeyance any approval of other NYSE "hybrid" proposals until a revised, over-arching regulatory framework governing specialist dealer activity is agreed upon.

The Revised "Sweep" Methodology

The NYSE's discussion of its revised "sweep" methodology is a masterpiece of disingenuousness. In its original proposal, the NYSE had provided that a trade initiator seeking to access liquidity with the benefits of an electronic "sweep" had to trade at only two prices: the displayed price, and a "clean up" price. The trade initiator could not obtain the benefit of better prices at successively higher (lower) prices so as to obtain the best overall price for its order. In its proposed revision, the NYSE would now provide that a trade initator may trade at such successively higher (lower) prices. However, public orders on the public limit order book at such successive prices must split executions with hidden floor broker go along orders. And the brokers' hidden go along orders (which are public orders) must split executions with the specialist's hidden go along dealer orders.

In my correspondence on SR-NYSE-2005-05 over the past year and a half, I have repeatedly emphasised how the NYSE's original proposal represented a radical departure from the way its market had traditionally operated, and would significantly transform the economics of large order execution on the NYSE. Simply put, the NYSE had always permitted a trade initiator to trade at successively higher or lower prices. The effect of the NYSE's original proposal was simply to force trade initiators to accept worse overall prices for their orders, to the principal benefit of broker and specialist hidden go along orders. And nowhere in its original proposal did the NYSE even acknowledge that it was radically changing the dynamics, and economics, of large size order execution.

Predictably, the professional trading community was outraged by the NYSE's sheer chutzpah here in favoring its floor constituency at the expense primarily of institutional investors. The NYSE is trying to spin its revision as a "customer accommodation", but all it has been really forced to do is retreat back to the status quo ante, at least as far as a trade initiator is concerned. (De facto, this is just about the only instance in the "hybrid" market where the NYSE is, however reluctantly, actually "replicating" the auction market, again at least as far as a trade initiator is concerned).

While the NYSE's proposed revision cures the problem of fundamental unfairness to a trade initiator, it does not address at all the very critical problem of fundamental unfairness to the public limit order book.
In its Regulation NMS releases, the Commission repeatedly emphasised the importance of public limit order protection, and the centrality of public limit orders to the price discovery process. The NYSE proposal, however, permits hidden go along orders to seriously undermine the

viability of the public limit order book. In its "hybrid" market approval order, the Commission simply brushed this hugely significant issue aside, making the throw-away observation that the NYSE proposal had "retained incentives" for the placement of public limit orders. The professional trading community views this statement as ludicrous, and one which adversely affects the credibility of the SEC staff. (See, e.g., the June issue of Traders Magazine, in which buy side traders are quoted as saying that the NYSE "hybrid" market is no place to post liquidity).

The problems with hidden go along orders being allowed to compete on highly advantageous terms to the detriment of the public limit order book have been discussed at length in my correspondence on SR-NYSE-2004-05, and have not been meaningfully addressed by the SEC staff. (It is particularly important that the discussion in my November 8, 2005 letter on this point be incorporated by reference here).

Simply put, the problems are the following:

(1) The NYSE proposal to permit hidden go along orders to compete directly with the public limit order book at successive price levels creates a fundamentally "unlevel" competitive playing field. The hidden orders can be entered with knowledge of the fully disclosed public limit order book. Those entering such public limit orders have no knowledge of the hidden orders, however, and therefore no opportunity to adjust their limits in response to this invisible competition for executons.

(2) The NYSE proposal to permit such hidden go along trading erodes the price/time priority of the public limit order book. Hidden orders, entered later in time and in response to orders fully displayed on the public limit order book, will deny executions, or seriously diminish the size of executions, to orders with clearly established time priority.

(3) It is fundamentally unfair and anticompetitive to allow hidden go along orders to undermine the quality of public limit order execution. The public limit order book is fully displayed, and is, in essence, the "magnet" that attracts incoming liquidity. (Hidden orders by definition cannot attract liquidity). Yet the NYSE proposal would deny, or seriously undermine, the executions of the very orders that are attracting contra side liquidity to begin with.

(4) The NYSE's rules on splitting executions (so-called "parity") are particularly unfair to the public limit order book. The NYSE rules create what I have referred to as a "bites of the apple" problem. Each individual hidden go along order is entitled to a proportionate split, but the public limit order book is considered to be only one entity, regardless of how many individual orders are entered on the public limit order book at a particular price. Thus, for example, if there are nine hidden go along orders competing with the public limit order book, which may have ten orders at that price, each individual hidden go along order gets a 10 percent split, and the public limit order book, which contains more orders, all of which may have been entered prior in time, gets only a single 10 percent split. It is difficult to imagine a "splitting" system more inherently unfair than this.

And this does not "replicate" the auction, because even floor brokers tell me that in most instances, after a trade that exhausts a particular price level (what will happen in successive price sweep trading), the specialist will immediately quote a new price with the public limit order book having priority (no splitting).

(5) The NYSE's approach is fundamentally inconsistent with the approach it has been forced to take with respect to executions at the prevailing bid or offer price. In the face of sharp public criticism, the NYSE was forced to modify its original "hybrid" proposal to permit go along orders to compete directly with the public limit order book at the price of the prevailing quotation only to the extent that the go along orders are published in that quotation. In other words, hidden go along orders cannot compete directly with the public limit order book at the displayed bid or offer price. The NYSE has made no case whatsoever as to why hidden go along orders should nonetheless be allowed to compete directly with the public limit order book at other price levels. The best the NYSE could do was a resort to linguistic flim-flam about brokers designating a share amount that "would be displayed", but which in fact is never displayed in sweep transactions. This absurd fictional construct about an imaginary "would be displayed" share size solves absolutely none of the problems of hidden order trading in sweep transactions.

(6) The proposal to permit hidden specialist go along orders to compete directly with (split executions) with the public go along orders of floor brokers is clearly illegal under Section 11A of the Securities Exchange Act, and is illegal under the negative obligation as well. (See my June 23, 2006 comment letter for a full discussion on this point). Both the floor broker community and the Investment Company Institute are on record with the Commission as being strongly opposed to such specialist competition.

(7) Hidden order trading in general raises significant issues of market transparency and market structure, with potentially serious adverse consequences for fair and efficient price discovery in a true national market system. As I discussed at length in my June 23, 2006 comment letter, this is a subject requiring separate Commission scrutiny.

There is only one fundamentally fair way for conducting sweep transactions. Displayed orders should trade ahead of orders that are not displayed, and hidden floor broker public go along orders should trade ahead of the specialist's dealer go along orders. Period.

Conclusion

Quite obviously, the NYSE's rule submission raises very serious issues. Many of these issues were alluded to, in a vague, conclusory fashion, in the SEC's "hybrid" market approval order, but the issues were not dealt with in any meaningful analytical way. To date, the SEC staff has appeared to bend over backwards to accommodate the NYSE, accepting at face value almost anything the NYSE represents, even when the NYSE's positions (to the extent it presents any) have been demonstrated to be substantively non-responsive to public criticism.

The SEC staff must do better. The types of conclusory assertions the SEC has been presenting in its "hybrid" approval orders are clearly inadequate, given the fundamental legal issues involved. In fact, the "hybrid" approval orders stand in sharp contrast to the analytically sophisticated work product the public has come to expect as a matter of course from the SEC staff when dealing with complex, sensitive subject matter. There has clearly been an unsavoury air of "realpolitik" about this entire process.

Another round of conclusory assertions about "basis under the Act", unsupported by any legal reasoning whatsoever, simply will not do.

The Commission owes it to the public to come to terms fully and completely with the serious issues involved here, and to act decisively in the interests of public investors, and not in the self-serving interest of the NYSE and its trading floor constituency.

Sincerely yours,

George Rutherfurd
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