

December 8, 2006

Dear SEC:

Let me start with what journalists call the "money quote", a term that fits here both literally and figuratively. In an article by Gregory Bresiger in the December 6, 2006 issue of Traders Magazine, we find the following sentence about the NYSE's proposal:

"Some NYSE officials privately say this new interpretation will provide a revenue boon to specialists."

Make no mistake, this is exactly what drives this proposal, as the NYSE is crowing privately about what its self-serving public posture seeks to obfuscate. And note the emphatic "will" rather than a conditional "may", and the word "boon", a sure-fire pocket-stuffer that will come as a great relief to the NYSE's specialist community, consisting as it does of such impoverished entities as Goldman, Sachs, Bank of America, Bear, Stearns, etc.

And, need one say, in the zero sum game of trading, the transfer of wealth represented by this "revenue boon" can only come at the direct expense of public investors.

This entire discussion needs to be framed around the "money quote", not the vague generalities and broad platitudes on offer from the NYSE, or the meaningless conclusory assertions on offer from the SEC staff as to how this mess can possibly be legal in the first place.

I will not repeat at length all the very specific and substantive criticisms I have made in my October 20, 2006 and November 14, 2006 comment letters, criticisms that the NYSE has been singularly unable to rebut. (I ask that those letters be incorporated by reference herein). But a number of points must be made about the SEC staff's clearly defective approval order:

(i) the ex post facto rationalisation on offer from the SEC staff as to how this matter (easily the most significant of all the "hybrid" market technical rule changes) has been "exposed" for public comment is truly an embarrassment to a Commission that has historically prided itself on "Government in the sunshine;"

(ii) the "re-interpretation" of the negative obligation makes no sense whatsoever as a matter of fact, law, or logic, or indeed of the SEC's own

experience with the negative obligation during the recent NYSE specialist trading scandal, and reflects the SEC staff's inability to distinguish between the affirmative and negative obligations;

(iii) not only are the SEC staff unable to distinguish between the affirmative and negative obligations, they do not even understand fully what the NYSE's "hybrid" market rules provide or how they work, as reflected in the ignorance of footnote 80 of the approval order;

(iv) because the SEC staff do not fully understand how the NYSE's "hybrid" market really works, they are unable to comprehend the significant, anti-competitive advantages being given to specialists, advantages that are more significant than any that ever existed in the physical auction (hence the "revenue boon");

(v) in setting forth the monitoring conditions for the pilot approval of "conditional transactions" (largely unrestrained specialist trading in the NYSE's active stocks), the SEC staff emphasize the very trade-by-trade regulatory approach that they otherwise repudiated in "re-interpreting" the negative obligation, a contradiction indicative of the overall difficulties the SEC staff have in dealing with this material;

(vi) the SEC staff continue to ignore the manifest applicability of Section 11A(1)(C)(v) both to the instant proposal, and to specialist go along ("parity") trading, and, when challenged, flatly refuse to provide, as statutorily required, any explanation as to "burden on competition" and "basis under the [1934] Act" as to direct specialist competition with public order execution.

The Negative Obligation and the Saperstein Interpretation

The negative obligation appears in broad terms in SEC Rule 11b-1 and is more fully fleshed out in NYSE Rule 104. The negative obligation was deleted from Section 11(b) of the Securities Exchange Act in 1975, with Congress giving the SEC the authority to eliminate the negative obligation if such a restriction on specialist dealings were to become unnecessary due to competitive factors and the elimination of specialist trading advantages. Although the NYSE's competitive picture was much more adverse in 1975 than it is today, the Commission declined to act on the Congressional grant of authority. As discussed below, the second condition clearly has not been met, as the NYSE's "hybrid" market confers upon the specialist trading advantages significantly in excess of those

ever enjoyed by the specialist in the physical auction.

The recent NYSE specialist trading scandal is further confirmation of the continued relevance of the negative obligation in today's markets.

SEC Rule 11b-1 provides that the rules of a national securities exchange must include provisions "restricting [a specialist's] dealings so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market."

NYSE Rule 104 states that "No specialist shall effect [dealer trades]...unless reasonably necessary to permit such specialist to maintain a fair and orderly market...."

Other provisions of Rule 104 flesh out what is meant by a "fair and orderly market." These provisions, collectively, form an integrated, seamless whole as to what constitutes the "negative obligation." Critical here is paragraph Rule 104.10(1), which states that "The maintenance of a fair and orderly market implies the maintenance of price continuity with reasonable depth and the minimizing of the effects of a short-term disparity between supply and demand." Other provisions of Rule 104 mandate (with a few technical exceptions) that the specialist may trade only in a "stabilising" manner, i.e., against the market's price trend, so that a specialist's purchases do not support an upward price move, and the specialist's sales do not support a downward price move.

Thus, under the negative obligation, a specialist may trade only to offset a temporary disparity in supply and demand, and only in a manner that stabilises the market.

In the late 1930s, the SEC adopted the so-called Saperstein interpretation of the negative obligation, which posited that the necessity for any dealer trade was to be determined on a trade-by-trade basis. The Saperstein interpretation has endured unchanged since its adoption, testament to its effectiveness as a fundamental tenet of specialist regulation.

The rationale underlying the Saperstein interpretation is obvious: it is the only possible interpretation that is consistent with the language of the negative obligation. The market dynamic of whether a specialist should not be permitted to trade unless to offset a short-term disparity in supply and demand arises only in the context of a particular trade: either there is, or there is not, such a disparity in each, case-by-case trading situation.

If there is no disparity (public orders can interact

without dealer intervention), there is no "necessity" for the specialist's trade, which will only displace a public order capable of execution.

If there is a short-term disparity in supply and demand, meaning that a specialist's trade will ensure appropriate trade-to-trade price continuity without displacing a public order, the specialist is not only unconstrained by the negative obligation, but in fact is required to trade under the affirmative obligation. As discussed below, both the NYSE and the SEC staff have had difficulty in distinguishing between the affirmative and negative obligations.

The Needle in a Haystack Approach to Public Notice and Opportunity for Comment

The fundamental issue raised by this matter is of overarching significance: to what extent should a monopoly dealer in a primary market be permitted to interfere/compete with public order interaction and execution? Given the magnitude of this issue, it is readily apparent that the NYSE's proposed "re-interpretation" of the negative obligation is by far the most important rule change proposed by the NYSE in conjunction with the "hybrid" market.

But the manner in which this critical subject is being treated, a subject that goes to the very essence of how a "fair" market should operate, raises serious questions about the SEC staff's professional judgment.

As originally submitted on September 22, 2006, 2006-76 contained a proposal that, in practical effect, would largely eliminate specialist stabilisation requirements, particularly in active stocks, which account for virtually all the trading activity on the NYSE. This is, in essence, an abandonment of the specialist's historic mandate to act only when stabilising the market.

On October 5, 2006, the NYSE submitted 2006-82, which was given accelerated (immediate) effectiveness by the SEC staff with no opportunity for prior public comment. This gave "temporary" approval, until October 31, 2006, of 2006-76 and 2006-65, another problematic "hybrid" proposal.

Slipped into the middle of 2006-82, and presented as though it were a nagging administrative detail, were several paragraphs (no actual rule amendment) that, in practical effect, would largely eliminate the negative obligation by "re-interpreting" the Saperstein interpretation. Although the NYSE proposal directly impacted one of the Commission's oldest rules, Rule

11b-1, the SEC staff simply acted on their own here with respect to matter that, when properly considered, effectively neutered the most important tenet of all specialist regulation.

Subsequently, and again with no opportunity for prior public comment, the SEC staff approved 2006-96, which extended the "temporary" approval until November 30, 2006. In the interim, the NYSE submitted an amendment to 2006-76 that simply restated the brief, superficial discussion of the negative obligation contained in 2006-82. The SEC staff never re-published amended 2006-76, with the negative obligation material, for prior public comment.

Thus, the most significant of all the "hybrid" rule changes was effectively buried, with no opportunity for prior public comment, in a rule submission described on both the NYSE and SEC websites as being about something else entirely, a "pilot" program to test systems.

In response to my comments that a matter of this significance should have been published for prior public comment, the SEC staff merely noted (p. 38 of the approval order) that the proposal was published as part of the post-approval order in 2006-82, and that therefore the Commission's "public notice" requirements were satisfied.

There is, of course, as the SEC staff are well aware, a huge difference between a pre-approval public comment period, and an essentially pro forma post-approval comment period. Commenters frequently send in pre-approval comments, and SROs frequently amend proposals in response thereto. That is exactly how the process worked with respect to 2004-05, the NYSE's basic "hybrid" market rule submission.

Post approval comments are rarely sent in, and virtually never result in changes, because commenters feel (quite rightly) that such comments would simply constitute a fruitless academic exercise because the Commission had already acted. The SEC staff are being entirely disingenuous in equating a pre-approval comment period with a post-approval comment period.

As I noted above, the website descriptions of the rule submissions contained no clue that the NYSE was in fact proposing to "re-interpret" the negative obligation. The fact that I came upon it by accident, thinking I was reviewing a systems test proposal, can hardly suggest that the general public thereby had adequate notice, as the SEC staff brazenly suggest at the very end of the approval order.

Notwithstanding the manifest significance of this

issue, the public could have no clue what was actually involved here, unless they read an SEC release that purported to be about something entirely different. And if the public did read the release, and, quite fortuitously, came upon the negative obligation proposal effectively buried in the middle of a description of a systems pilot program, they would only discover that the matter had already been approved any way.

It is not too much to say that the attitude of the SEC staff is simply this: if you accidentally stumble across a needle in a haystack while you are looking for something else entirely, feel free to send in an almost certainly fruitless post-approval comment.

The approval order for 2006-76 runs 39 pages, a good portion of which are devoted to the negative obligation. That fact alone is testament to the significance of the underlying issues, and the singular inappropriateness of how this matter has been "presented" for public comment.

If the radical revision of the most important tenet of specialist regulation is not a subject for prior public comment, what ever would be?

The SEC staff stand rightly accused of an egregious lapse of professional judgment here.

The "Re-Interpretation" of the Negative Obligation Makes Absolutely No Sense As Presented

The NYSE proposed to delete the Saperstein interpretation's trade-by-trade necessity test, and replace it with a "pattern or practice" test that focused on whether a specialist's trading "caused or exacerbated" "excess" market volatility (no definition provided). Presumably, under this "re-interpretation", a specialist would be found liable for a violation of the negative obligation only if he or she engaged pro-actively in trading that resulted in adverse market impact.

In my comments, I pointed out that the proposed "re-interpretation" could not be reconciled with the word "necessary" in the rule (i.e., a particular trade, not a "pattern", is either necessary or it isn't). I also observed that, based on the NYSE's own enforcement experience, "excess" volatility results from too few dealings under the affirmative obligation, rather than too many dealings under the negative obligation.

In essence, the NYSE (as it has in other contexts)

confused the affirmative and negative obligations. In my comments, I pointed out that Rule 104 is drafted as a "specialist cannot trade unless reasonably necessary" codification. A trade-by-trade (Saperstein) approach is the only one consistent with that type of drafting, because "necessity" can only be determined in terms of an immediate trade and whether, at that particular point in time, there is a disparity in supply and demand warranting specialist intervention.

A specialist cannot know whether subsequent trades that may be part of a "pattern" are necessary because subsequent order flow will dictate pricing, market direction, and, on a case-by-case basis, whether specialist intervention is appropriate as to any particular trade.

The obvious problem with commingling "necessity" and "pattern" is that the broad pattern may be okay if there is no unusual price movement, but many individual trades within that pattern may not be "necessary" at all, but are just in-and-out profit taking that interferes with public order execution (exactly the case with the recent specialist trading scandal).

The NYSE's response to this criticism was absolutely incoherent. The NYSE agreed with me that in-and-out profit taking that interfered with public order execution would in fact constitute a violation of the negative obligation. But this "revised" NYSE position contradicted what it stated in its rule submission about the need to rescind a focus on individual trades, and replace it with a focus on broad "patterns." The NYSE rather witlessly came full circle here, as the only way to review in-and-out trading is to take a trade-by-trade necessity test approach (as per what the SEC and NYSE did as to the specialist trading scandal).

In effect, the NYSE's "re-interpretation" of the Saperstein interpretation appears to be the exact same as the original, obviating the need for any of this mess in the first place. But I have no doubt that the NYSE really would like something new here, as the NYSE is determined to increase specialist proprietary trading opportunities (the "revenue boon" beast must be fed, after all). But the NYSE quite clearly doesn't have a clue how to articulate anything that even remotely makes sense here.

As bizarre and arcane as all this seems, it is hardly an academic matter. The NYSE has taken only one major enforcement action in at least the past 25 years with respect to the negative obligation. This fact alone is testament to the fact that, notwithstanding unsubstantiated assertions by both the NYSE and the

SEC staff, the negative obligation is hardly the impediment to specialist trading that they would have us believe. But that one enforcement action was the recent specialist trading scandal, in which the "pattern" of trading was fair and orderly, but individual trades, as detected by the Saperstein interpretation's trade-by-trade necessity test, were deemed violative. The NYSE's own very recent experience confirmed the viability of the Saperstein interpretation, and the NYSE has made absolutely no case to the contrary as to why it should be discarded.

One of the many answered questions in the SEC staff's approval order is why the SEC staff would entirely ignore the NYSE's own recent experience with the viability of the Saperstein interpretation, particularly given the importance placed on this matter by the SEC's Division of Enforcement, and the fact that the Commission had to censure and fine the NYSE for failing to properly interpret, surveil, and enforce the negative obligation. The Division of Market Regulation and the Division of Enforcement (which may have pending cases under the trade-by-trade Saperstein interpretation) are clearly not on the same page here, which hardly enhances confidence that the Commission itself is really on top of all this.

A good deal of the problem is the manifest inability of the Market Regulation staff to clearly distinguish between the affirmative and negative obligations, a confusion abetted by the NYSE's own incoherence on this point. On page 29 of the approval order, the SEC staff note (approvingly) the NYSE's "rationale" for the proposal: "NYSE believes that specialists will contribute vitally to the hybrid market by committing capital and adding liquidity in order to bridge gaps in supply and demand, which can help to keep the market fair and orderly and reduce volatility." The SEC staff conclude (p. 32) that "eliminating the trade-by-trade standard with respect to the negative obligation should enhance the specialist's ability to fulfill its obligation to maintain a fair and orderly market."

The problem here for both the NYSE and the SEC staff is that the obligation to maintain a fair and orderly market arises primarily under the affirmative obligation, not the negative obligation. (In the recent specialist trading scandal, the markets were fair and orderly, but individual trades were violative). It is as though the SEC staff were concluding that the negative obligation has to be effectively rescinded so that specialists can perform their affirmative obligation, a position that is absurd by any measure and is contradicted by the NYSE's own enforcement experience.

Specialists have never been constrained under the negative obligation from "committing capital", "adding liquidity", "bridging gaps in supply and demand", "reducing volatility", etc. This is absolutely the specialist's critical function, and the negative obligation, as my research indicates, has never been a factor in NYSE enforcement proceedings for failure of specialists to perform under the affirmative obligation. The NYSE's own enforcement profile makes clear that the problem is lack of pro-active performance under the affirmative obligation (usually because specialists become very skittish about one-way price moves), not too much constraint under the negative obligation. The SEC staff need to go back to the drawing board on this point.

And the notion that the "speed" of trading makes a trade-by-trade necessity test impractical cannot withstand simple scrutiny. As I have pointed out (and the NYSE has singularly failed to rebut), the specialist's algorithm can easily be programmed to facilitate specialist trading under the affirmative obligation, and constrain specialist trading under the negative obligation.

Automation, in fact, makes it far easier, not more difficult, for specialists to comply with the trade-by-trade necessity test.

In the event, the SEC staff have fallen into the conceptual and linguistic black hole created by the NYSE. The SEC staff adopt the NYSE's "pattern or practice" test, but take pains to emphasise that the negative obligation is not being eliminated, and that "specialists must continue to assess their need to trade and limit their proprietary trades to those reasonable necessary to allow the specialist to maintain a fair and orderly market"(p. 32).

All well and good, but how exactly does one determine whether trades are "reasonably necessary" unless one focuses on individual trades and does a trade-by-trade analysis? The Division of Enforcement certainly needed to do this in the recent specialist trading scandal. Surely, the SEC staff would not tell an investor disadvantaged by a particular specialist trade, "Not to worry, you were disadvantaged, but take comfort that the broad pattern was okay, so the specialist is off the hook." Or is this the SEC staff's new "standard" for protecting investors: problematic individual trades don't matter, only the overall pattern.

I'm certain this is not really the SEC staff's position. But they have clearly and witlessly come full circle here, as did the NYSE: the Saperstein

interpretation is dead, long live the Saperstein interpretation!

Obviously, the SEC staff cannot both adopt a "pattern" test and at the same time insist that trades be "reasonably necessary", because these are mutually exclusive concepts. The wisdom of the Saperstein interpretation, and the reason that it has endured for more than 70 years, is that a trade-by-trade necessity test is the only approach that makes sense of the term "reasonably necessary" in the text of the rule. The matter couldn't be simpler: either a particular trade is "necessary" or it isn't. "Pattern" simply does not, cannot, enter into it.

The upshot of all this is truly baffling. Even if this made sense conceptually, which it clearly doesn't, it is impossible to read the text of the rule and understand that "reasonably necessary" means "pattern", or to understand clearly when specialists may or may not trade under the "re-interpretation." There are just certain inherent limitations to the English language.

In my comments, I emphasised the need for the NYSE to proceed by way of a formal amendment to rule text here (assuming something coherent could be put together, which is highly doubtful), and not by way of a "re-interpretation" that was flatly inconsistent with, and could not be derived from, the text of the rule.

One would have not have thought the advocating of clear, direct rules would be problematic. But the SEC staff have adopted a rather bizarre position on this. In the SEC staff's view (footnote 82), since the original Saperstein interpretation was not incorporated in rule text, there is no need to amend rule text to codify the "re-interpretation."

The problem with the SEC staff's position is obvious: the trade-by-trade necessity test is clearly implied by the term "reasonably necessary", as necessity can only be determined in the context of a particular trade. No way, no how, is "pattern" implied by "reasonably necessary."

This conceptual and linguistic black hole is hardly the SEC staff's finest hour (although it gets worse, as discussed below). They have, quite simply, been unable to distinguish clearly between the affirmative and negative obligations, and have been mouse-trapped by the NYSE into adopting a non-sensical position riddled with internal contradictions.

Investors have the right to demand clear rules, particularly where the activities of a monopoly dealer in a primary market are concerned. This matter needs

to be re-examined, and, at a bare minimum, the following steps need to be taken:

(1) The NYSE must be made to submit an appropriate amendment to the text of the negative obligation itself, rather than proceed by means of a rule text-inconsistent "re-interpretation."

(2) The NYSE must be made to present this rule amendment in plain English, and discuss, in plain English, the impact and practical consequences of its proposal on public order execution.

(3) The NYSE must be made to present a detailed legal analysis as to how its proposal is consistent with Section 11A of the 1934 Act, which by its plain terms is intended to minimise dealer intervention with public order execution.

(4) The matter must be published for prior public comment. And, as this matter involves a radical change in the application of a long-standing, fundamental SEC rule, the Commission must issue its own release seeking public comment on any "re-interpretation" of Rule 11b-1.

At the conclusion of the public comment period, a matter of this consequence should be considered at an open meeting of the Commission. In the unlikely event the Commission determines to issue some sort of approval order, such order must contain a detailed analysis of all relevant legal issues.

The SEC Staff Have Committed Serious Errors of Fact in Permitting Specialists to Enjoy Clearly Anti-Competitive Trading Advantages

It is difficult to read the approval order without concluding that the SEC staff are simply overmatched intellectually by the demands of having to work with this highly arcane subject matter. Understandable certainly, excusable no, because there are serious adverse consequences to public investors arising from the failure of the SEC staff to clearly understand (i) how trading is actually conducted on the NYSE; (ii) the practical effects of what the NYSE's "hybrid" rules mean (as opposed to what they say; and (iii) what actually motivates specialists' trading decisions.

The NYSE's comment letters and the SEC staff's approval order are littered with references to national market system developments, competition, automation, dispersion of information, and the like. There is nothing particularly "wrong" in any of this,

but these are meaningless truisms, yesterday's news, and hardly what this matter is really all about. This background noise tends to obscure what is really germane here: that which takes place solely within the NYSE marketplace, and the degree to which, within that market, the NYSE has created a highly "unlevel" playing field whose principal beneficiary is the specialist. This is what will produce the "revenue boon" that NYSE officials are privately crowing about.

In its comment letters, the NYSE was forced to concede that specialists do indeed have informational and trading advantages in the "hybrid" market, but sought to characterise them as "slight." It goes without saying, of course, that "slight informational advantage" in a rapid-fire electronic trading environment is an oxymoronic concept. And any professional trader (which the specialist most certainly is) absolutely salivates at the prospect of a world in which he or she knows what others want to trade, but no one else knows what he or she will trade.

And this is precisely the world that the SEC staff, in their ignorance and naivete, have delivered to the specialist on a silver platter.

The SEC staff expressed their view in their approval order that the specialist's informational and trading advantages were "diminished" in the hybrid market. But, as I demonstrate below, they reached their conclusion, in two highly material particulars, based on significant errors of fact that call their overall credibility here into serious question.

Footnote 80, states the following: "The Commission [really the SEC staff acting under "delegated authority", would that it really were the Commission] notes that the commenter's [yours truly] assertion that specialists have the exclusive ability to trade with incoming marketable orders is incorrect. Floor brokers are permitted to execute against incoming marketable orders via d-quotes. See NYSE Rule 70.25(b)(i). In addition, the commenter [yours truly again] asserted that specialists have access to floor broker agency interest data. This statement is likewise inaccurate. Specialists' algorithms will not have access to such data...."

I was clearly correct in my statements, and the SEC staff have made highly material errors of fact here, errors that demonstrate that the SEC staff do not understand clearly what the NYSE "hybrid" rules say or what they mean.

The SEC state that floor brokers are permitted to execute against incoming marketable orders, and they

cite Rule 70.25(b)(i). This rule states the "price condition" for executability of d-quotes (hidden, contingent limit orders), and a superficial, out-of-context reading of the rule would appear to support the SEC staff's position. But context is king. So-called d-quotes are executable only when both the order's "price condition" and "size condition" are met. The "size condition" rule, Rule 70.25(c)(iii), provides, "Only displayed interest will be used by Exchange systems to determine whether the size of contra side volume is within the d-quote's discretionary size range. Contra side reserve interest and other interest at the possible execution price will not be considered by Exchange systems when making this determination."

The problem for the SEC staff here is that marketable orders are never "displayed" (quoted) but rather receive an immediate, automated execution. Since a d-quote's "size condition" can never be satisfied against an undisplayed marketable order, the d-quote will never be executed against such orders. (The SEC staff were not helped here by the confusion of 2006-36, the d-quote proposal. Statements in that submission by the NYSE could be read to suggest that d-quotes trade with marketable orders, but the way the rules are actually drafted indicates that this is not the case. I raised this point several times, and the NYSE was singularly unable to rebut my position here).

This is very technical, but highly material. What it means, in effect, based on the way the NYSE has actually written its rules and designed its systems, is that the specialist's algorithm has been given the exclusive franchise to know about, and trade with, incoming marketable orders, a huge, anti-competitive informational and trading advantage.

I have previously made this point, and given the NYSE ample opportunity to rebut it, but they have singularly failed to do so. I am at a total loss to understand how it is that the SEC staff do grasp what is really going on here.

The SEC staff also make the bizarre claim that specialists do not have access to "floor broker agency interest data" (floor broker public customer hidden limit orders). Again, a superficial, can't-see-the-forest-for-the-trees reading of the "hybrid" rules might appear to support the SEC staff's position. But this is clearly not the case.

Under the rules, the specialist is not given information about the specific details of any individual floor broker hidden order. But the specialist, and only the specialist, receives the most material piece of information about these otherwise

hidden orders, which is the aggregated buying or selling interest at each particular price point. And the SEC staff need not take my word for it. The NYSE itself told this to the SEC staff. In its comment letter on 2006-36, the NYSE stated (p. 5), "Specialists will be able to view only total aggregated broker agency interest at each price." The "only" is misleading, because it is hardly a substantive limitation.

If the SEC staff do not understand the materiality of the information the specialist receives here, they have absolutely no business reviewing proposals such as this. A specialist does not need to know the details, "discretionary instructions", etc. of any particular order. What is material information to the specialist is the aggregated information, because this is the information that will be used in making the specialist's trading decision. But the SEC staff appear entirely clueless here as they proceed to give away the store.

So much for the SEC staff's credibility as to the "diminishment" of specialist informational and trading advantages. In fact, the following are the specialist's "diminished" advantages, all greatly in excess of anything the specialist ever enjoyed in the physical auction:

(1) Notwithstanding the SEC staff's misplaced assertions to the contrary, the specialist's algorithm has the exclusive informational and trading franchise as to incoming marketable orders. In the physical auction, the specialist had to expose such orders to the trading crowd, and could trade with them only if no one else wanted to.

(2) Only the specialist's algorithm is embedded in NYSE's systems and can "read" and react to incoming orders the instant they enter NYSE systems. In the case of non-marketable orders (limit orders priced between the quote) the specialist's algorithm can effect a trade the instant the order is "published." Any algorithms used by "outsiders" can only react to an order after it is "published", by which time the specialist's algorithm will have already traded with it. The NYSE has disingenuously posited as a "safeguard" here a "delay time" which purportedly inhibits the specialist's algorithm during the "transit time" between entry of an order into NYSE systems and arrival of the order on the display book. But, as I have repeatedly pointed out, this "delay time", a matter of a nanosecond or two, is a fictional construct, not a meaningful inhibition, and the NYSE has had no answer. In practical effect, the specialist's algorithm has been given the exclusive algorithmic franchise, to the competitive disadvantage

of any outsider algorithm, to trade with non-marketable orders. This is as "unlevel" as a playing field gets.

And the contrast with how a specialist had to act in the physical auction could not be starker. As with marketable orders, everything had to be exposed to the immediate market, and the specialist could trade only if no one else wanted to. The "tilt" of the playing field has been entirely reversed here.

(3) The specialist alone of all market participants, whether within or without the floor, is given information about floor broker public customer hidden limit orders (in aggregated, but highly material, form) as discussed above. Thus, the specialist knows at what prices to compete with them, or where to "price improve" by the minimum increment to deny them an execution. This is a trader's fantasy come true: the specialist knows where the hidden orders will trade, but the floor brokers do not where the specialist will trade. It is deeply disturbing that the apparently naive and clueless SEC staff could have approved this, as it directly disadvantages public customers to the dealer's benefit.

(4) The specialist's algorithm has exclusive knowledge of incoming "sweep" orders the instant they enter NYSE systems, and has the exclusive ability to "layer the book" (compete with both displayed and hidden orders) to take the contra side at advantageous prices in response to this information.

(5) The information being given to the specialist's algorithm about marketable and non-marketable orders, floor broker hidden limit orders, and "sweep" orders is highly material, non-public market information. In the physical auction, the specialist may have had access to non-public market information, but could not act on it until the information was disclosed and orders exposed, with the specialist acting only as the trader of last resort pursuant to the NYSE's order exposure rules.

In the "hybrid" market, however, the specialist not only has, exclusively, highly material non-public market information, but gets to act on it ahead of everyone else in most instances. This is insider trading under any standard, with the witless SEC staff acting as aiders and abettors.

What I have described above is absolutely the way the "hybrid" market, stripped of the NYSE's self-serving rhetoric, actually works. No one who understands markets, and what informational and trading advantages really mean and how they operate, could possibly claim that specialists' privileges have been diminished,

when in fact they have been radically enhanced.

Revenue boon, indeed.

The SEC staff have deeply embarrassed themselves and the Commission here. The Commission cannot to continue to permit an SEC staff who clearly lack the requisite understanding to deal with this subject matter to continue to operate under "delegated authority." Given the SEC staff's material errors of fact, and inability to apply legal standards correctly, the Commission has ample grounds to revisit this matter.

The SEC Staff Have Defaulted to the Saperstein Interpretation in the Context of Monitoring "Conditional Transactions"

As should be readily apparent by now, the SEC staff's approval order is hardly a model of intellectual consistency. And there is a particularly significant inconsistency at the heart of the SEC staff's discussion of "conditional transactions."

This term is typical of the NYSE's obfuscatory jargon. What it means is that the specialist, largely freed from the restraints of the negative obligation and traditional requirements to stabilise the market, can freely trade, for the most part, in the S & P 500 stocks, the stocks that account for virtually all of the NYSE's volume. There is nothing really "conditional" about this; had the NYSE been intellectually honest, it would have referred to these as "unconditional transactions." (In its typically Orwellian/Ministry of Truth use of language, it is par for the course for the NYSE to call that which is really unconditional "conditional").

In my comments, I noted this was a particularly egregious aspect of the NYSE's proposal, as NYSE specialists would be permitted to do the most damage to public investor orders in the stocks in which, by all historical measures, their participation was least needed. Surprisingly, the SEC staff did not note even a single one of my comments here, although it is obvious from the approval order that they share my sentiments, even if they are not inclined to fully act on them and reject this aspect of the proposal out of hand.

The problem for the SEC staff here is that in approving this mess (even on only a pilot basis), they have placed themselves squarely in the middle of a legal no man's land. They are required to approve proposals only if they are "consistent" with the requirements of the 1934 Act. But what is on offer

from the SEC staff is well below this rather clear-cut standard. The SEC staff state, "The Commission [actually the SEC staff, would that it were the Commission] believes that the provisions governing Conditional Transactions [really unconditional] in Active Securities [the S & P 500 stocks, the NYSE's only active securities, other than ETFs] may reflect an appropriate balance between the needs of specialists and other market participants in today's fast moving markets."

Note how the SEC staff have fudged this. Although they are required to find that the proposal is "consistent" with the 1934 Act, the best the SEC staff can do is state that the proposal "may" (meaning of course that it may not) reflect an "appropriate balance" between the specialist's needs and the needs of other market participants. The SEC staff's use of such conditional language, which does meet the requisite legal standard, suggests that the SEC staff are actually holding their noses as they approve this, as well they should. They offer no discussion whatsoever as to what an "appropriate balance" might be, because, in reality, there is none. If public orders can trade without dealer intervention, Section 11A(1)(C)(v) clearly indicates that they must do so. If there is a need for a dealer trade, the affirmative obligation mandates that the specialist act. There is nothing to "balance" here, because either the specialist's trade is necessary and appropriate, or it isn't. And if it is not "necessary", it simply constitutes unwarranted interference with public order execution.

What the SEC staff have witlessly approved is really a new form of aggressive specialist proprietary trading largely unrelated to the market making function. (Revenue boon, anyone?) And such trading will inevitably degrade the quality of public order execution, as it provides for artificial specialist intervention where public orders themselves "make the market". The specialist's trading simply competes unnecessarily with the public, and contributes to the exhaustion of liquidity at particular price levels, with public orders then having to "buy up" or "sell down" as a result.

Section 11A(1)(C)(v) clearly precludes this type of dealer trading. But, here and elsewhere (see discussion below), the SEC staff have been incapable of relating the statutory proscription to the dynamics of what actually happens in the NYSE market.

To give the SEC staff a degree of credit, they obviously realise they are on very shaky legal ground with all this. They approved "conditional transactions" only on a "pilot" basis until June 30, 2007, and have imposed monitoring and reporting

conditions on the NYSE. But what is at the heart of the monitoring conditions? None other (see p. 36) than a "trade-by-trade analysis of market activity". As I stated above, the Saperstein interpretation is dead, long live the Saperstein interpretation!

I am trying to be fair, but it is difficult to avoid the conclusion that the SEC staff are simply clueless.

At a bare minimum, the results of the NYSE's "monitoring" should be submitted to the Commission in Form 19b-4, as part of any request to extend or make permanent the "pilot" program. And there must be a fair prior public comment period.

But the real answer here is for the Commission itself to step in, re-examine this entire matter, and apply the negative obligation and Section 11A(1)(C)(v) fully and fairly to protect the interests of public investors.

The Commission Has Erroneously Approved Specialist "Go Along" Trading

As the instant proposal implicates the negative obligation, it is appropriate herein to address another matter in which the SEC staff has failed to understand the applicability of the negative obligation and Section 11A(1)(C)(v) to the actual dynamics of trading in the NYSE market. In its approval order for 2004-05, the basic "hybrid" proposal, the Commission itself approved specialist "go along" ("parity") trading in direct competition with public orders, and in a manner having nothing to do with performance of the market making function. The Commission's approval order did not explain the "basis under the Act" for this approval, nor did the order analyse this matter in terms of "burden on competition", as the Commission is statutorily required to do. Obviously relying on inadequate staff work, the Commission simply offered what are substantively meaningless conclusory assertions as to this matter.

It is worth presenting the text of Section 11A(1)(C) (i)-(v) here:

"It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure

(i) economically efficient execution of securities transactions;

(ii) fair competition among brokers and dealers, and between exchange markets and markets other than exchange markets;

(iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;

(iv) the practicability of brokers executing investors' orders in the best market; and

(v) an opportunity, consistent with the provisions of clauses (i) and (iv) of this subsection, for investors' orders to be executed without the participation of a dealer."

As subparagraph (v) makes clear, it is a fundamental objective of the national market system that public orders be given the maximum opportunity to interact directly with each other. Congress' wisdom is readily apparent: public-to-public trading at a particular price will ensure that the fairest prices are discovered.

Subparagraph (v) is conditioned only by the reference to subparagraphs (i) and (iv). Absent one of these two subparagraphs being applicable, subparagraph (v) must be strictly enforced, as there are no other statutorily-permitted exceptions or qualifications.

Thus, dealer participation might be permissible if needed to promote either economically efficient execution of securities transactions (subparagraph (i)), or the practicability of brokers' executing investors' orders in the best market (subparagraph (iv)). But absent either subparagraphs (i) or (iv) being applicable, subparagraph (v) clearly mandates that public orders be allowed to trade directly with one another without dealer participation.

The NYSE's permitting a specialist's hidden go along order to trade on parity (split an execution with) a floor broker's hidden public order is clearly illegal under Section 11A(1)(C)(v), and was vigorously protested by the NYSE's major public customers and those who represent them. (See comments from the Investment Company Institute and the Independent Broker Action Committee submitted in conjunction with 2004-05).

This is the problem here: the floor broker's public order is fully capable of trading with the incoming contra side public order, without the specialist's dealer intervention. There is no issue concerning economically efficient execution, as the floor broker's hidden order will provide an immediate,

automated execution in the same manner as the specialist's hidden order would. There is clearly no issue under subparagraph (iv), because this is an entirely intra-NYSE matter.

There is another huge problem for the NYSE here: permitting specialist go along competition with public orders is not only unnecessary from the standpoint of efficient order execution, but, in fact, makes the order execution process less economically efficient. Such specialist go along competition forces the incoming contra party to have to settle the trade with an additional, and unnecessary, contra, the specialist, when the incoming contra party could more efficiently settle with just one party, the floor broker. It is axiomatic that the fewer parties to trade settlement, the more efficient the overall trading process.

The Section 11A issue is extremely important to public investors, as "forced" dealer intervention results in less of a "fill" for public orders, and ultimately degrades the quality of public order execution.

This type of "forced" dealer intervention clearly violates the negative obligation as well. Such dealer trading is never "necessary" to maintain a fair and orderly market, as the requisite market depth and liquidity are already being provided by the public orders at the same price at which the specialist is competing.

In the 2004-05 approval order, these matters were briefly alluded to in the SEC staff's superficial and incomplete summary of public comments, but were not dealt with analytically at all. The SEC staff have subsequently refused to provide any explanation whatsoever as to "burden on competition" and "basis under the [1934] Act" as to this matter, noting simply that the Commission had approved the matter.

The Commission and the SEC staff are bound by clear, black letter law as to specialist trading that interferes with direct public order execution. This is not a case where the SEC staff are arguably misinterpreting the law. Rather, and except for the occasional, meaningless conclusory assertion, the SEC staff are simply ignoring the law altogether.

These continued attempts by the SEC staff to simply default to a prior, clearly inadequate approval order are widely perceived as the intellectual equivalent of a street hustler's shell game. No matter what shell one looks under, there is no pea. And so it is with the "hybrid" market approval order. No matter where one looks, there is no independent legal analysis or justification. All one finds are in-passing,

substantively meaningless conclusory assertions, the functional equivalent of turning over an empty shell.

The Commission must insist that the clear-cut law of the land means what it says and will be enforced, and that the interests of public investors come before the NYSE's dealers, revenue boon or not.

Conclusion

The NYSE proposal is on a collision course with reality in its reactionary attempts to turn back the clock to mythical halcyon days of high specialist dealer trading rates. As the national market system evolves and electronic trading becomes the norm, markets in deep, liquid stocks will naturally "make themselves" a good deal of the time. Congress clearly envisioned this in Section 11A, and emphasised direct public order interaction without artificial dealer intervention. This is, quite simply, the new and natural order of things.

The NYSE simply cannot have it both ways: it cannot create an efficient electronic marketplace that obviates to a large extent the need for specialist intervention, and then propose "rule changes" that promote dealer trading/interference/competition any way, and regardless of traditional market making necessity. And make no mistake, this is exactly what the NYSE proposal is all about.

Be that as it may, material aspects of the proposal are clearly illegal, and the SEC staff's "work product" is hugely deficient, with its material errors of fact, muddled conceptual analysis, and manifest failure to apply the law appropriately. It is well past time for the Commission itself to step in and act decisively.

Sincerely yours,

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organisations)
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