October 20, 2006

Dear SEC:

This letter is addressed to what the NYSE has submitted to date on the above-referenced matter, and the representations concerning the "negative obligation" that appear in SR-NYSE-20006-82.

In my comment letters on SR-NYSE-2004-05 (the NYSE's basic "hybrid" market rule submission) and on other "hybrid" market proposals, I have repeatedly emphasised the NYSE's pointed failure to address the over-arching, historic framework of specialist regulation, the affirmative and negative obligations and other restrictions on specialist proprietary dealings. (To the limited extent the NYSE made a minimal effort to acknowledge these obligations, as in its September 21, 2005 comment letter on SR-NYSE-2004-05, it famously mistook the affirmative obligation for the negative obligation, a gaffe that still produces chuckles in the professional trading community. As unintentionally funny as this appeared at the time, there is no humour whatsoever in the fact that the NYSE continues to confuse the affirmative and negative obligations in the instant rule submission).

I have pointed out how the NYSE (and the SEC in approving the NYSE's proposals) had engaged in classic "cart before the horse" rulemaking in proposing radical new forms of specialist trading without first addressing the profoundly inconsistent regulatory structure.

My comments expressed dismay at the SEC staff for allowing this to happen. Given the disdain displayed by the NYSE for addressing these issues, one can only conclude that the SEC staff have (finally) exercised moral suasion here (translation: they browbeat the NYSE) and required the NYSE to deal with the specialist regulatory framework.

But what the NYSE has proposed is breathtaking in its sheer audacity when one considers the NYSE proposal in light of the actual dynamics of specialist algorithmic trading, and the exclusive trading privileges being conferred upon the specialist. Make no mistake: the NYSE (in the guise of a "re-interpretation") is proposing the de facto rescission of the negative obligation and abandonment of the historic "specialist system", and replacing it with a quasi-dealer/quasi uniquely privileged proprietary trader system.

And the NYSE has provided virtually no justification for any of this. The NYSE merely resorts to assertions about "competition" and "automation" as though the mere utterance of these terms were sufficient to

forestall intelligent thought or empirical analysis. In actual fact, as demonstrated below, the competition/automation factors do not support the NYSE's position at all when subjected to logical scrutiny, and when relevant historical comparisons are made.

The NYSE's purported "safeguard", a requirement that specialists "re-enter" the market after engaging in what has always been deemed (with good reason) to be destabilising trading demonstrates either contempt for the intelligence of the professional trading community, or abject cluelessness on the part of those drafting the NYSE's proposals. As demonstrated below, far from having to be "required" to "re-enter" the market, specialists in fact salivate at the prospect, because this is the (obvious and fundamental) way that specialists make their money as intra-day "flip" traders.

The NYSE seems oblivious to the fact that its Orwellian use of language (recalling 1984's Ministry of Truth) has resulted in a significant loss of credibility, as the professional trading community has disregarded the hypocritical, self-serving assertions and focused on the raw emphasis on promoting floor constituency self-interest.

A few personal favourites (there are many) from the NYSE's Ministry of Truth:

(i) calling hidden, conditional limit orders (which can only be entered by floor brokers) "quotes", even though they are never quoted;

(ii) referring to a volatility surge protector as a "liquidity replenishment point", even though the brief time out in most instances will have nothing to do with "replenishing" "liquidity";

(iii) claiming that the benefits of physical auction trading endure, even as it rescinds or re-defines to the point of meaninglessness the rules that provided such benefits;

(iv) claiming that the "hybrid" market "replicated" the physical auction, even as it conferred trading privileges on its floor constituency well beyond any that ever existed in the physical auction;

(v) claiming that the specialist's "time/place advantage" disappears in the "hybrid" market, even as it confers an outrageous, per se anti-competitive time/place advantage in cyberspace (where "hybrid" trading is conducted) upon the specialist's exclusive algorithm; and

(vi) referring to the increased "transparency" of the NYSE market, even as it promotes a hidden order trading methodology that has led the professional trading community to conclude that the NYSE is not a market on which to display limit orders;

(vii) claiming to be responsive to the needs of its professional trading customers, even as it requires them to assume unnecessary expense and delay in retaining the services of a floor intermediary to simply enter an electronic order for an intermediary-less execution;

(viii) claiming to promote the notion that floor brokers should be able to protect their customers from unwanted specialist competition, even as it refuses to allow floor brokers to object in any meaningful way to such competition in "hybrid" market trading.

In SR-NYSE-2006-82 and 76, the NYSE is attempting to bring an early Christmas to its specialist community in its proposals to effectively remove the most meaningful constraints on specialist dealer activity. In typical Ministry of Truth fashion, the NYSE would have us believe that the unambiguous term "necessary" actually means "not necessary, but broadly okay", and that the unambiguous term "destabilising" actually means "neutral or otherwise okay." I'll give the NYSE this much: there's no pretense of subtlety here.

I would urge the SEC staff to take cognisance of more than 70 years of effective specialist regulation, and that the NYSE has made no case whatsoever for overturning a framework that has well-served public investors.

The various "hybrid" market approval orders to date reek of an inexplicable "realpolitik." In their drafting, the SEC staff have had to repeatedly default to the meaningless standard that the NYSE's proposals are "broadly" consistent with the Securities Exchange Act, terminology that rarely appears in an SEC release or approval order, as "consistency" (without qualifier) with the Act is the generally accepted legal standard and typical SEC formulation. One imagines the SEC staff holding their noses even as they draft the approval orders. (Some of my comments have been critical of the SEC staff, though not unfairly so, and I respect that they have been placed in a difficult position on these matters).

The Negative Obligation

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. In the 31 years following this Congressional action, the SEC has not acted on this authority, presumably because of an (entirely appropriate) assessment that the negative obligation continues to be both necessary and appropriate, as demonstrated in particular by the recent NYSE specialist trading scandal. As demonstrated below, the NYSE has mischaracterised the Congressional rationale as to this matter.

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 reasonable necessary to permit him to maintain a fair and orderly."

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 temporary 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 price trend, so that the specialist's purchase 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, testiment 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 otherwise 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.

These supply/demand equilibrium assessments arise in the context of a particular trade; hence, the wisdom of the long-sustained Saperstein interpretation's trade-by-trade approach.

The key to understanding the Saperstein interpretation in today's markets is thus to focus on the concept of whether or not the specialist's trade displaces a public order otherwise capable of execution. If a public order can be so executed, there is no "market maintenance" necessity for the specialist's trade, because the requisite depth, price continuity, etc. is provided by the public order. The specialist's trade adds nothing positive, but rather imposes the huge negative of public order displacement, notwithstanding the "liquidity" (a favourite NYSE cure-all term) provided by the specialist.

As the NYSE's actual enforcement posture with respect to both the affirmative and negative obligations makes clear (and which is discussed below), the negative obligation today is not really addressed to market "manipulation" or to trading which fuels unusual price movement. Specialists are typically risk-averse, intra-day "flip" traders, who seek to maximise opportunities to conduct in-and-out trading. They do not seek to "hold" positions, and so have no incentive to manipulate the market to enhance their value. Similarly, they have no incentive to fuel one-way price movements, as this will only diminish their "flip" trading opportunities. (As discussed below, unusual price movements are affirmative, not negative, obligation territory).

One need only look to the recent specialist trading scandal on the NYSE to understand exactly the point I am making here. Both the NYSE and the SEC made a big

deal about how the specialists had violated the negative obligation by "interpositioning" or "trading ahead of" public orders otherwise capable of execution, in order to maximise "flip" trading profits. This is classic Saperstein interpretation trade-by-trade analysis, as there was no "necessity" for the specialist to trade in any of these particular instances, even though the specialist did not manipulate the market, or cause or exacerbate price volatility, and even though the overall trading pattern surrounding individual violative trades could be said to be fair and orderly.

As I demonstrate below, the NYSE's proposed re-interpretation of the Saperstein interpretation flies in the face of its own recent experience with the continued viability, indeed critical importance, of the Saperstein interpretation.

The negative obligation on the NYSE has always operated in conjunction with the NYSE's mandatory order exposure rules. All orders in the auction were required to be "exposed" (publicly bid or offered) before a trade could take place. Whether or not a public order would be displaced by a specialist's trade could be readily assessed. The specialist had to make a bid or offer on behalf of any order sent by Superdot before the specialist could trade with the order. Only if, following this exposure process, no other market participant traded with the order could the specialist then effect a dealer trade with an incoming order, as this manifested an immediate (and trade-by-trade) disparity in supply and demand such that the specialist's trade could be deemed to be "reasonably necessary." The specialist's role is, in essence, to act only as the "trader of last resort", with the market itself, not the specialist, determining the "necessity" for the specialist's trade.

The NYSE's Proposals

When one dispenses with the NYSE's self-serving rhetoric and drills down to the essence of its proposal, it is obvious that the NYSE is seeking the de facto rescission of the negative obligation, and the de facto abandonment of the specialist's historic mandate to stabilise the market by trading counter to the price trend.

With respect to the negative obligation, the NYSE has requested the Commission to "re-interpret" the Saperstein interpretation to eliminate the trade-by-trade necessity test. Since the Saperstein interpretation is the trade-by-trade necessity test,

the NYSE is really proposing the elimination of the Saperstein interpretation, and its replacement with a new interpretation. This new interpretation would assess the "necessity" for specialist trading based on a specialist's "pattern or practices" in effecting dealer trades. The actual focus of the pattern or practices" will be on trading activity that "appears to cause or exacerbate an excessive price movement in the market." According to the NYSE, it will focus its surveillance activity on this type of trading, which "would appear to be in violation of the specialist's negative obligation."

The NYSE has not proposed an amendment to the text of Rule 104 in this regard, nor has it addressed the critical element of the negative obligation that a specialist is permitted to trade only to offset short-term disparities in supply and demand.

With respect to stabilisation, the NYSE proposal would effectively eliminate any stabilising requirement when a specialist liquidates or decreases a position. When a specialist is establishing or increasing a position, there would be no stabilisation requirement as to buying on bid or selling or offer, and no stabilisation requirement when trading within the published quotation, or during a sweep transaction. Furthermore, in the most actively traded stocks (those comprising the S & P 500 Index, the stocks in which specialists make virtually all of their dealer profits), the specialist would be permitted to initiate directly destabilising price changes, i.e., buy at directly higher prices, sell at directly lower prices.

The only "safeguard" on offer from the NYSE with respect to specialist destabilising trading is the "assurance" that NYSE surveillance will monitor whether the specialist has appropriately "re-entered" the market (i.e., attempts to sell what he or she just bought) after effecting a destabilising trade.

The NYSE is less than forthcoming about what all this technical gobble-dee-gook really means in practical trading terms. One has to plow through reams of the least readable prose ever produced by the legal "imagination" (the various NYSE "hybrid" market rule proposals) to get a clear picture here.

But what emerges is singularly ugly, and 180 degrees at variance from the historic NYSE market model. This is not evolution, it is revolution, it is not "replication" of the auction, but radical new invention, and it is not fair competition, it is egregious enhancement of monopoly privilege.

In practical effect, the NYSE specialist (by means of

the algorithm) is being given the exclusive privilege of trading with all incoming systematised marketable orders, without regard to last sale prices and whether such transactions would directly influence the direction of market prices. With respect to limit orders, the specialist's algorithm again has exclusive trading privileges (subject only to occasional "splitting" of an execution with a floor broker's hidden public order), as the algorithm, deeply embedded in NYSE systems, gets to pounce on the order the instant it is "published." (The NYSE has suggested that a "transit time" between entry of the order in NYSE systems and appearance on the display book obviates the specialist's advantage, but the "transit time" consists of a meaningless delay measured in nanoseconds). In active stocks, the specialist not only has exclusive trading privileges, but can directly initiate destabilising price changes.

The NYSE has "rigged the game" so that the specialist may seize proprietary trading opportunities before the rest of the world becomes aware of, much less can react to, incoming order flow. Furthermore, the specialist has exclusive knowledge of floor broker hidden public orders, can algorithmically trade around them, or can "split" executions with them, even if such public orders were entered earlier in time.

In all of this trading (which, as with virtually all specialist trading, takes place at or within the published quotation, well below the NYSE's proposed surveillance radar, which will be looking at "excessive" price movements), the specialist is unconstrained by whether the trades are "necessary" in order to maintain a fair and orderly market, and unconstrained by whether or not the specialist is directly influencing the market's price trend. Since orders are no longer meaningfully exposed to the market, the broad market is denied the opportunity to determine whether a specialist's trade is necessary. The determination of the "necessity" for the specialist's trade is the exclusive prerogative of the specialist's algorithm. In other words, the specialist himself, not the market, gets to determine whether the specialist's trade is "necessary", a 180 degree reversal from the way the NYSE market has always worked.

The handcuffs have come off, and the specialist's fantasy wishlist becomes reality. (And not just with respect to trading. The SEC staff, acting under delegated authority, approved a huge reduction in specialist capital requirements, such that, in relation to volume, specialist capital requirements are now significantly below the universally-disparaged levels of pre-crash 1987. See SR-NYSE-2005-38, and comments thereon. And I reiterate my request that the

SEC publish my August 2, 2006 letter on this matter). As discussed below, "market making" gives way to aggressive proprietary trading, as the specialist can, for all intents and purposes, trade freely and exclusively at or within the NYSE quotation, and can directly influence the market's price trend.

The Obvious Problems with the NYSE Proposal and Its Rationale

For such a shockingly radical proposal, the NYSE has singularly failed to provide any meaningful rationale or justification. What little "argumentation" the NYSE does attempt to offer consists of little more than superficial cliche-mongering, entirely unaccompanied by empirical analysis.

With respect to the negative obligation, the NYSE quotes the following excerpt from the legislative history accompanying the deletion of the negative obligation from Section 11(b) of the Securities Exchange Act: "It might well be that with active competition among market makers and the elimination of trading advantages specialists now enjoy, such a restriction on specialists' dealings would become unnecessary."

In the NYSE's view, it is now appropriate to "re-define" the negative obligation because "institutionalisation of the market, increased competition, and increased application of computer and communication technology has significantly diminished the time-and-place advantages of specialists." Thus, says the NYSE, markets have seen "increases in the average daily trading volume and the movement off the floor of the decision making that affects the direction and extent of movements in the specialty stocks."

The NYSE's points here are entirely disingenuous. As noted above, the SEC has declined to act on the 1975 grant of authority, and with good reason. The excerpt from the legislative history quoted by the NYSE is a classic case of the devil quoting scripture for his own purpose, as the actual meaning of that excerpt is directly contrary to the NYSE's position (I am confident the SEC staff will readily ascertain this). As any fair reading of the legislative history makes manifest, Congress was concerned that the negative obligation would unduly constrain the ability of NYSE specialists to make competitive markets. Thus, Congress left open the possibility (but certainly didn't mandate) that the SEC might eliminate the negative obligation if appropriate so that specialists could compete on a "level" competitive playing field

with other market makers.

But what the NYSE is proposing is the exact opposite of what Congress had in mind. One needs to place in context the bleatings of the cry wolf, woe-is-me specialist community, furious that its egregious levels of profitability have declined (in the near term, sure to reverse as volume explodes in the "hybrid" market) to the merely reasonable. It is a meaningless truism that specialists face strong competition today (as they should), but it is also the case that the NYSE continues to be the dominant, primary market in its stocks by a huge measure.

In reality, and notwithstanding however one wants to characterise today's competition, the NYSE's competitive position now is far stronger than it was at the time of the 1975 Amendments. At that time, specialists faced far greater competition, from third market marketmakers, than they face today from all sources combined. NYSE market share hovered in the 60% range, NYSE specialist trading opportunities (measured by the NYSE's arcane TTV) were about half of what they are today, specialists' high fixed commission rates (at that time the source of most specialist income)were made illegal, and predictions of the NYSE's imminent demise were actually quite commonplace. That was the backdrop for Congress' action regarding Section 11(b), as Congress was concerned that the negative obligation might literally be a factor in putting the NYSE out of business.

This is hardly the case now. The NYSE's competitive picture today is much stronger than it was in 1975. Average daily trading volume is greater by a huge multiple, specialist dealer participation rates have about doubled against this huge volume, and predictions are that volume will quadruple in the "hybrid" market, meaning that specialists will have significantly greater trading opportunities going forward.

And the current rules do not at all inhibit the ability of specialists to make competitive markets, as specialists can match bids and offers on other markets irrespective of intra-NYSE "tick" restrictions. The NYSE's own marketing propaganda is always touting the continued competitive strength of the NYSE market. The NYSE contends (accurately, I believe) that, in comparison to other markets, its trade-to-trade price continuity statistics, and the market depth accompanying price changes, are far superior to other markets. Surely, the specialist's historic negative obligation, with its promotion and maximisation of direct public order interaction, is a highly significant factor in producing the NYSE's impressive, highly competitive market quality profile. It is other

markets that cannot compete in-depth with the NYSE, not vice versa.

The NYSE has recently been losing some market share (although market share is still well above the distressed levels of the early 1970s), but, if NYSE marketing propaganda is to be believed, this will be reversed with new "pricing" initiatives. This is typical of the NYSE's two-faced approach: it will tell the credulous SEC staff that the handcuffs have to be taken off of the specialists in order to meet "competition", while it tells the professional trading community, which knows better, that what it really needs to do is "re-price" its business to become more competitive.

And the NYSE's assertions about "institutionalisation" of the market and movement of pricing decisions off the NYSE floor are meaningless make-weight. These are principal factors that led to the 1975 Amendments (particularly the overhaul of Section 11(a) and the virtual elimination of on-floor trading) and are hardly "news" today.

There's an obvious question to be asked here: If, in 1975, when the NYSE's competitive position was much more adverse than it is today, the Commission nonetheless did not consider it appropriate to re-visit the negative obligation, why should it do so today, when the NYSE's competitive position is not only much stronger, but is expected to be greatly enhanced by the "hybrid" market?

This is clearly a question that answers itself: if there was no need for Commission action in 1975, surely there is no need for such action today.

Just as the first aspect of the legislative history excerpt (the point on competition) quoted by the NYSE cannot withstand logical scrutiny, the second aspect (the elimination of trading privileges enjoyed by specialists) similarly breaks down and falls apart. In fact, the NYSE is being particularly disingenuous on this point. First, there has been no "elimination" of specialist trading privileges today compared to 1975. Under current rules (essentially the same ones that existed in 1975), specialist trading opportunities (measured by TTV) are about double what they were in 1975. Clearly, the NYSE cannot point to any "trading privilege" that has been "eliminated" such that specialists cannot make competitive markets. On page 4 of SR-NYSE-2006-76, the NYSE makes the following, truly absurd and desperate statement: "The amendments also recognise that specialists have fewer opportunities to control or dominate the market in a security, particularly liquid securities or active trading situations." Let me state the obvious: it has

NEVER been the specialist's function to "control" the price of a security, or to "dominate" the market in a security. Presumably, under current rules, a specialist who did so would be ushered to the nearest jail cell.

In actuality, the NYSE is really complaining that in active stocks there is no need for the specialist to trade, which is as it should be, under both the negative obligation and Section 11A of the 1934 Act, which emphasises public order interaction without dealer intervention (more on Section 11A below).

The fact that specialist dealer intervention in active stocks is often unnecessary does not mean that a "trading privilege" has been "eliminated." Under applicable law and rules, specialists never had, in the first instance, the "privilege" of trading when their dealer participation was not required. And, since NYSE dealer participation rates are nonetheless quite high today in comparison to historical averages, it is clear that the NYSE specialist community is classically crying wolf here. Certainly, the NYSE has made no empirical case to the contrary.

But what is truly offensive in the NYSE's use of the legislative history excerpt is the fact that while the NYSE is pretending to bemoan the (non-existant in actual fact)elimination of specialist trading privileges, the NYSE is actually moving aggressively to enhance them. It is a meaningless truism to assert, as the NYSE does, that the specialist's trading floor time/place advantage disappears as trading moves from the floor to cyberspace (where virtually all "hybrid" market trading will take place). The real question is whether the specialist will then have a significant time/place advantage in cyberspace. And this question must not only be answered with a resounding yes, but with an acknowledgment that the NYSE is in fact proposing to confer a time/place advantage on the specialist in cyberspace far in excess of any that the specialist may have enjoyed in the physical auction.

The specialist alone has knowledge of floor broker hidden public orders, and can trade algorithmically to take advantage of what is clearly material, non-public market information. (The SEC staff have been particularly asleep at the switch on this point). Furthermore, the specialist's algorithm is given the exclusive ability to trade with incoming order flow, irrespective of whether any of it is necessary as that term has always been applied to specialist trading. The former "trader of last resort" has become the only one allowed in the queue to begin with. The public is entirely displaced here because it has no opportunity to engage in this type of trading, whereas the public clearly had the opportunity to trade ahead of the

specialist as orders were exposed to the entire market in the physical auction.

The NYSE clearly has made no showing to warrant the exercise of the SEC's authority to re-interpret the negative obligation. Nor has the NYSE made any showing why the specialist's historic role as a market stabiliser, historically an integral element of the negative obligation, should be effectively eliminated.

The NYSE again provides little more than broad, conclusory assertions in support of its position. The usual meaningless truisms are on offer: increases in volume and speed of market activity, competition, automation, etc. What the NYSE singularly fails to address in any meaningful way whatsoever is the real issue: Should a market maker with uniquely privileged trading opportunities be able to directly influence price movements in stocks, or should such price movements be determined by public order supply and demand, with the specialist playing only a "cushioning" role to prevent sharp price swings? Clearly, the Commission and the NYSE have always emphasised the need for the specialist to be a market stabiliser as a critical aspect of the maintenance of fair and orderly markets.

The NYSE makes the patently absurd statement on page 6 of SR-NYSE-2006-36 that "ticks no longer provide benchmarks in a rapidly changing market." In a great many professional trading strategies, of course, "ticks" indeed are are a benchmark of price direction, and any number of such strategies have tick-based components. Direct specialist influence on market price trends can only have an adverse impact on many public investor trading strategies.

What the NYSE is proposing is, in effect, direct and unnecessary specialist intervention in determining market price direction, which can hardly be said to serve the public interest. And the NYSE's egregiously self-serving statement that "more liberal trading ability [for specialists] is appropriate for active stocks" is truly appalling. These stocks, in particular, trade perfectly well (depth, liquidity, etc.) without unnecessary dealer intervention, yet it is in these stocks in particular that specialists would be given carte blanche to initiate directly destabilising price changes. In other words, the stocks in which the specialist is least needed are the stocks in which the specialist will be allowed to do the most damage.

And let's not forget the "safeguard" that the specialist must "re-enter" the market, a bit like demanding that a bank robber go back and grab that last pile of cash at the bottom of the till. One

couldn't make this stuff up if one tried, but the NYSE presents it straight-faced, without apparent embarrassment, as though it actually made sense. This is all a total sell-out to the specialist community to the direct detriment of public investors.

The NYSE is also bizarrely circumspect on the subject of automation. We are told about the speed of order entry and execution, and we are told about the "benefits" of the specialist's algorithm. But apparently automation is a one-way street for the woe-is-me specialist community, as automation (quite mysteriously) is apparently utterly incapable of helping specialists meet the demands of the historic negative obligation and the historic stabilisation requirements. This is, quite obviously, absolute hogwash. The very automation that the NYSE posits as the rationale for undoing more than 70 years of effective specialist regulation is, in actuality, the automation that makes it easier than ever for specialists to comply with, and be held accountable under, the existing rules.

The specialist's algorithm can easily be programmed to conform to the trade-by-trade negative obligation, and to conform to existing stabilising requirements, notwithstanding the "speed" of market activity.

This is the kind of automation the NYSE should be touting, and with the depth and liquidity of the NYSE market (and the forecast quadrupling of volume), there will be plenty of opportunities for the specialist to trade (and make money), while performing their historic market making function, not acting as aggressive, anti-competitive proprietary traders.

The Pitfalls of the NYSE's "Interpretation" and "Surveillance" Approach

The NYSE has not proposed to amend the text of Rule 104 (which codifies the negative obligation) but rather is proposing merely that the SEC "re-interpret" the Saperstein interpretation such that (this is difficult to piece together from the NYSE's vague concepts) a specialist would not be permitted to trade unless "reasonably necessary" to ensure that his or her "pattern or practice" of trading did not "cause or exacerbate" "excess market volatility." This just doesn't make any sense at all as a "negative obligation."

The NYSE's "interpretive" approach is not only amateurish and unprofessional in light of how Rule 104 is actually drafted, but it cannot be reconciled with the plain language of this simple, direct rule. 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 established in terms of an immediate trade and whether, at that immediate 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 problem with commingling "necessity" and "pattern" is that the broad pattern may arguably be okay if there is no unusual price movement, but many individual trades within the pattern may not be "necessary" at all, but are just specialist in-and-out profit taking that interferes with direct public order interaction. There is a fundamental problem arising from rule text here: either a trade is "necessary" or it isn't.

The Saperstein interpretation has endured for 70 years for an obvious reason: it is the only one that makes sense, given the way the rules are drafted. At a bare minimum, and as a matter of form, the NYSE needs to propose an amendment to Rule 104, and petition the Commission to amend Rule 11b-1, such that rule text itself clearly expresses the position espoused by the NYSE. As matters stand, the NYSE's proposed interpretation is flatly inconsistent with, and cannot be derived from, the text of the existing rules.

Be that as it may as to form, the NYSE's "re-interpretive" proposal is conceptually flawed. The term "pattern or practice" is void for vagueness, if not utterly meaningless, as is the term "excess volatility." And there is a bizarre circularity to the NYSE's reasoning. Each specialist apparently establishes his or her own "pattern or practice" based on the stocks they trade. The NYSE will then "surveil" to see if they conform to the "pattern" which the specialists themselves establish. The specialists are obviously being given the combination to the safe here, as the more aggressively they trade, the more they will be in a comfort zone when the NYSE conducts its "pattern analysis" surveillance.

For all intents and purposes, the NYSE is, in actuality, proposing the de facto rescission of the negative obligation because the "pattern or practice" test is an open sesame for unrestrained specialist trading (regardless of historic necessity), so long as it does not result in "excess" market volatility.

Surely, the NYSE can do better than this. But perhaps not. Given the fact that the NYSE was recently fined

and censured for failing to properly interpret and surveil the negative obligation, there is something deeply unsettling about the NYSE's "trust us, we can't tell you in advance what it is, but we'll know it when we see it" surveillance approach here. Once one discards the NYSE's pabulum about the wonderful "surveillances" it proposes to conduct, one is left with the stark, depressing reality of several of its key statements, which speak volumes about the NYSE's inherent problems here. The NYSE tells us that specialist activity that "appears" to cause or exacerbate excessive price movement "would appear" to constitute a violation of the negative obligation (page 8 of SR-NYSE-2006-82). Note the conditional subjectivity of "appears" and "would appear." Even when the specialist is going hog wild, the NYSE's initial response is to default to a tentative "would appear" criterion.

The NYSE is again confused about the distinction between the affirmative and negative obligations, which gives no comfort whatsoever that its surveillances can be properly targeted. Over the past 30 years or so (and certainly since the 1987 market crash), NYSE enforcement actions for violations of the negative obligation have been virtually unheard of. That is, until the recent specialist trading scandal, which involved application of the Saperstein interpretation. In that trading scandal, neither the NYSE nor the SEC made allegations about specialist trading that resulted in excess market volatility. Rather, the focus was on detecting the very occasional trade (according to the NYSE, violative behaviour occurred less that one half or one percent of the time, or about once every 200 trades or so)conducted at or within the quote, but which was not "necessary" under the historic necessity test. And both the NYSE and SEC were were clear (adamant in fact) that the trading scandal involved violations of the negative obligation.

The regulatory actions brought by the NYSE in cases of unusual price movement have all involved violations of the affirmative obligation. The problem in volatile markets, as the NYSE well knows, is not that specialist trading causes excess price movement, but just the opposite: specialists do not trade enough to counter the market trend. There is a simple explanation here: specialists seek to maximise profits by engaging in risk-reduced in-and-out intra day "flip" trading at or within the quote. They back off (as the NYSE's Rule 104 enforcement profile readily demonstrates) when one-way price movements introduce an element of significant market risk. The notion that "excess" price movements implicate the negative obligation is just not real world thinking, and this is confirmed by the NYSE's own experience. The

problems with the negative obligation are the trade-by-trade activity at or within the quote, as per the recent trading scandal.

So we are left with NYSE surveillance representations about the negative obligation that, based on the NYSE's own experience, are really appropriate to the affirmative obligation. It is obvious, notwithstanding the fact that the Commission had to slap it down for failing to understand and enforce the negative obligation, that the NYSE still doesn't quite get it. And while NYSE regulators are well-intentioned, the very softness of the "would appear" mindset lends itself to all sorts of special pleading by specialists when they are caught with their hands in the cookie jar. A fair reading of the SEC's settlement order with the NYSE suggests that this is exactly the problem NYSE regulators got themselves into with respect to the recent specialist trading scandal. Vague, undefined "standards" that inevitably lend themselves to subjective and varying interpretations, and a pre-disposition to "reasonableness" on the part of regulators susceptible to special pleading, are a recipe for disaster, and have led to two SEC enforcement actions against the NYSE in the last ten years.

This is serious stuff, and the Commission must be sensitive that public perception, not an SRO's self-serving assertions, is the critical element in investors having confidence in the fairness and orderliness of the market.

Clearly, hard-edged, specific standards are called for here, both from the standpoint of effective, substantive, meaningful regulation, and from the standpoint of investor confidence in the integrity of the NYSE.

The NYSE must be made to retain the negative obligation and dealer stabilisation requirements in their current form, and to demonstrate to the Commission and to the public that it can, in fact, conduct effective, automated surveillance as to these matters.

The Abandonment of the "Specialist System"

It is clear that the NYSE is, in fact, proposing to abandon its historic "specialist system" (while retaining the rubric), but the disturbing picture that emerges places the NYSE squarely in a "legal no man's land." Three of the specialist's critical functions (as touted by the NYSE over the years) disappear entirely in the "hybrid" market. The specialist is no

longer meaningfully an "agent" for Superdot orders on the display book, because the specialist neither represents nor executes them; these functions are performed by an NYSE computer. The specialist no longer conducts an actual auction, as an NYSE computer conducts electronic trading. The specialist is no longer a communicator of relevant market information, as the (few) limit orders entered on the display book are publicly disseminated, but the floor broker hidden orders, while known to the specialist, remain hidden from the investing public.

The one specialist function that ostensibly remains, market making, has been transformed into something entirely unknown by historical precedent and existing law and rules. The NYSE gives the game away in the very descriptive language it uses in SR-NYSE-2006-76 and 82. Repeatedly, the NYSE uses the term "trading opportunities" rather than "market making responsibilities" to describe the effect of its proposals to essentially rescind the negative obligation and eliminate dealer stabilisation requirements. The result is a "dealer" free to engage, with exclusive algorithmic prerogatives, in aggressive proprietary trading entirely unrelated to the specialist's historic market making function. The only "market making" function that remains to any degree is the affirmative obligation, and doubtless the NYSE staff are working feverishly behind the scenes to water that down as well.

The NYSE has thus replaced the "specialist" with a monopoly dealer/proprietary trader, and, by allowing the specialist alone to electronically intercept orders and engage in algorithmic trading, has created the most "unlevel" competitive playing field imaginable. The SEC staff have consistently refused to work through the fundamental, and critical, underlying legal issues here. I'll review a number of the most significant:

1. The specialist is permitted to trade to take advantage of material, non-public market information.

2. The specialist is permitted to engage in aggressive proprietary trading unrelated to anything that has been historically considered to be part of the market making function, in direct violation of Section 11(a) of the 1934 Act, which limits a specialist's proprietary dealings to those in which he or she is acting in the capacity of a market maker.

3. The specialist is allowed to compete aggressively with public orders ("parity" trading) in direct contravention of the negative obligation, as there is never any necessity for the specialist's trade when the public orders are providing the requisite depth

and liquidity, and there is no disparity between supply and demand.

4. Most egregiously, the specialist is permitted to compete aggressively with public orders in direct contravention of Section 11A of the 1934 Act. It is worth presenting the text of Section 11A(1)(C)(i)-(iv) 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, among exchange markets, 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, without dealer intervention. Congress' wisdom is readily apparent: public-to-public trading at a particular price will ensure that the fairst 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 with a floor broker's hidden public order is clearly illegal under Section 11A(1)(C)(v), and has been vigourously protested by the NYSE's major customers and those who represent such customers. (See comments from the Investment Company Institute and the Independent Broker Action Committee submitted in connection with SR-NYSE-2004-05). 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 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, it 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.

There is clearly no issue under subparagraph (iv), because this is an entirely intra-NYSE matter.

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.

In its approval order of the "hybrid" market (SR-NYSE-2004-05), 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 approval order can hardly be cited as a precedential cure-all here, because the approval order simply did not deal with the fundamental legal issues involved. (See my March 27, 2006 comment letter on the approval order for an in-depth discussion of this matter).

The refusal of the SEC staff and the Commission to deal fairly with the fundamental legal ssues is a matter approaching public scandal. This is not a case where the Commission is arguably mis-interpreting the law. Rather, and except for the occasional, meaningless conclusory assertion, the Commission is simply ignoring the law altogether.

This is a matter that is becoming ripe for referral to an appropriate Congressional oversight committee.

The SEC's Rule Approval Process

Far too many of the NYSE's "hybrid" market proposals have been approved by the SEC staff acting under delegated authority, notwithstanding that the proposals raise fundamental issues of public policy and fairness mandating full review and approval by the Commission itself. The one rule submission approved by the Commission itself, SR-NYSE-2004-05, resulted in what must be the most analytically deficient approval order ever issued by the SEC on a significant topic. And this matter should have been handled at an open, public meeting, as far less significant NYSE proposals had been handled that way in the past.

It is absolutely unconscionable that the SEC staff, acting under delegated authority, gave accelerated approval to SR-NYSE-2006-82, with no opportunity for prior public comment. This approval order, intended solely to accommodate an NYSE "implementation schedule" (another case of putting the cart before the horse), gave "temporary" approval to what is, in effect, the gutting of the Commission's Rule 11b-1 with respect to the negative obligation by "re-interpreting" the Saperstein interpretation, so integral an aspect of the rule that it is, de facto, a part of it.

It is difficult to believe that the Commission really gives, or should give, the SEC staff the delegated authority to act independently and directly countermand one of the Commission's own rules.

In the event, the instant proposal must not be handled by the SEC staff acting under delegated authority. The redefinition of the market making function on a dominant and primary market such as the NYSE, and the transformation of that function into one that allows aggressive proprietary trading unknown as a matter of precedent and in direct competition with public orders, is a matter of overriding public interest that must be discussed at a Commission open, public meeting.

Because the Saperstein interpretation has been such a long-standing, well-settled, and integral aspect of Rule 11b-1, any proposed "re-interpretation" is de facto an amendment to Rule 11b-1 itself.

At a bare minimum, the Commission needs to issue its own rulemaking release seeking prior public comment on

this de facto Rule 11b-1 revision.

Conclusion

It is not the Commission's task to ensure NYSE specialist profitability levels by maximising their proprietary trading opportunities.

It is the Commission's task to enforce applicable law strictly, to put the interests of public investors ahead of dealer interests, to maximise public order interaction without dealer intervention, and to create as "level" a competitive playing field as possible.

It really is that simple.

Sincerely yours,

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