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Via email to rule-comments@sec.gov

November 6, 2006

Nancy M. Morris, Esq.
Secretary
Securities and Exchange Commission
Station Place
100 F Street, NE
Washington, DC 20549

Re: SR-NYSE-2006-76 ("NYSE Stabilization filing")

Dear Ms. Morris:

The New York Stock Exchange (the "Exchange" or "NYSE") is writing to respond to three letters (3) letters[1] submitted by one commenter in response to the Securities and Exchange Commission's (the "Commission" or "SEC") solicitation of comments in connection with the NYSE Stabilization filing.[2]

Certain of the comments raised in the letters relate to rule changes covered in other NYSE filings, including SR-NYSE-2004-05 (NYSE HYBRID MARKET℠ filings; the "Hybrid Market"),[3] SR-NYSE-2005-38 (Specialist Organization Capital Requirements)[4] and SR-NYSE-2006-82 (Pilot related to Phase III of the Hybrid Market),[5] which have

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[1] See George Rutherfurd, Consultant, dated October 11, 2006 ("Rutherfurd I"); George Rutherfurd, Consultant, dated October 20, 2006 ("Rutherfurd II"). George Rutherfurd, Consultant, dated October 26, 2006 ("Rutherfurd III"). Hereinafter referred to as "the commenter." As none of the commenter's letters include pagination, pages references herein are based on the way in which his letters appear on the Commission website.

[2] See Securities Exchange Act Release No. 54504 (September 26, 2006), 71 FR 57011 (September 28, 2006) (SR-NYSE-2006-76). The Exchange submitted Amendment No. 1 to the Stabilization filing on October 25, 2006.

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

[4] See Securities Exchange Act Release No. 34-54195 (July 24, 2006), 71 FR 43260 (July 31, 2006).

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

already been approved by the SEC. Other comments concern general market structure issues or topics not specific to the amendments proposed in the subject filing. Accordingly, this letter responds only to substantive comments on the amendments proposed in SR-NYSE-2006-76 (Stabilization filing).

Background

Specialists on the NYSE are required to trade for their own account in order to maintain, in so far as is reasonably practicable, continuous two-sided fair and orderly markets in the securities in which they are registered. By committing capital, specialists provide depth and price continuity in their securities, moderating volatility and lowering execution costs for customers. Specialist trading is subject to certain conditions, referred to as the affirmative and negative obligations. SEC Rule 11b-1, requires the NYSE to have in place rules imposing these obligations.[6] The affirmative obligation requires the specialist to trade as principal when necessary to minimize an actual or reasonably anticipated imbalance between supply and demand. See e.g. Exchange Rule 104.10(2). The negative obligation requires specialist trading to be reasonably necessary to render the specialist's position adequate to the immediate and *reasonably anticipated needs* of the market and provides an opportunity for public orders to be executed against each other within the context of the current market without undue dealer intervention. See e.g. Exchange Rule 104.10(3). Stabilization requirements, which restrict the specialist's ability to trade, are an expression of the negative obligation.

Exchange Rule 104.10(5) sets forth the specialist's stabilization obligations with respect to trading as dealer in the stocks in which he or she is registered. The rule requires that unless the specialist's trading is reasonably necessary in the context of the current market or anticipated needs of the market, a specialist should not effect a destabilizing principal transaction (i.e., a transaction with the trend of price movement) when acquiring or increasing a position. In this regard, the rule restricts specialists from purchasing stock at a price above the last sale (in the same trading session) or purchasing more than 50% of the stock offered on a "zero plus tick," (i.e. at the same price as the last sale, when such last sale price was higher than the previous, differently priced sale in the stock on the Exchange) without Floor Official approval or, in less active markets, where the transactions are an essential part of a proper course of dealings and the amount of stock

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6 See SEC Rule 11b-1(a)(2)(ii) and (iii). Subsection (ii) which sets forth what has been described as the "affirmative obligation" requires that "a specialist engage in a course of dealings for his own account to assist in the maintenance, so far as practicable, of a fair and orderly market…" (emphasis added).

Subsection (iii) which sets forth what has been described as the "negative obligation" requires that specialists' dealings be restricted so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market…"

traded and the price change (if any) are normal in relation to the market, provided the specialist re-offers or re-bids where necessary after effecting such trades.

In other words, Exchange Rule 104.10(5) does not utterly prohibit such trades; rather, they are permissible provided they are reasonably necessary, a Floor Official approves them or they are in less active markets, and the specialist introduces liquidity into the market by re-entering on the contra-side at an appropriate price and in a commensurate size.

Exchange Rule 104.10(6) sets forth the specialist's stabilization requirements when liquidating or reducing a position. This rule provides that such trades should be effected in a reasonable and orderly manner, in relation to the condition of the general market, the market in the particular security and the adequacy of the specialist's position to meet the immediate and anticipated needs of the market in the security. Specialists are permitted to liquidate or reduce a position by selling stock on a "direct minus tick" (i.e. selling stock at a price lower than the price of the last sale on the Exchange) or by purchasing stock on a "direct plus tick" (i.e. at a price higher than the price of the last sale on the Exchange), if such transaction is reasonably necessary and the specialist has obtained Floor Official approval; there are no size conditions to such trades. After such transactions (including sales on "zero minus ticks" and purchases on "zero plus ticks") specialists should re-enter the market on the opposite side in an appropriate amount, where the imbalance of supply and demand indicates that immediately succeeding transactions may result in lower (following a specialist's sale) or higher (following a specialist's purchase) prices.[7]

Thus, as is the case when the specialist establishes or increases a position, destabilizing principal transactions when liquidating or reducing a position are not absolutely forbidden; they too are allowed, provided they are reasonably necessary, are approved by a Floor Official and are followed by appropriate re-entry on the contra-side of the market.

The Saperstein Interpretation ("Saperstein"),[8] issued by the SEC in 1937, discusses the factors for determining whether there is reasonable necessity for a specialist's proprietary transaction. According to Saperstein, reasonable necessity must be shown on a trade-by-trade basis.

The negative obligation and stabilization rules and interpretations described above were appropriate for and worked well in a market where substantially all trading was

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[7] The Floor Official approval requirements in Rules 104.10(5) and (6) do not apply to trading in securities commonly referred to as exchange-traded funds or ETFs. See Exchange Rule 104.10(7).

[8] See Securities Exchange Act Release No. 1117, 1937 SEC LEXIS 357 (Mar. 30, 1937).

conducted manually, at a pace that enabled an individuals to discern "tick" changes easily and which tolerated the time it took to call a Floor Official into the Crowd to approve a specialist's proposed destabilizing transaction. However, that market will no longer exist. In its place is the Hybrid Market, where trading is substantially electronic and the speed and frequency of executions and quote changes preclude individuals from being able to accurately track "ticks" or stop trading to allow for Floor Official involvement. Indeed, Regulation NMS ("Reg. NMS"),[9] demands nothing less and for the Exchange to operate otherwise would frustrate the SEC's intent in enacting those rules. Similarly, evolutions in the securities industry, including the growth of competition within and among markets, and the introduction of new trading technologies have altered the marketplace. Accordingly, amendments to the stabilization rules and a more modern approach to the reasonable necessity test are necessary to reflect the market place that exists *today*, not a relic of the past. The Exchange's current proposals do this by continuing the reasonable necessity test for specialist principal transactions and continuing the requirement that there be appropriate re-entry after such trades. They also recognize that there is no longer an opportunity for human intervention in the midst of normal trading and that flexibility in specialist trading at certain prices within the context of the market is appropriate.

Response to Comments on Proposed Stabilization Amendment

In general, the commenter posits nothing more than the proposition that the Saperstein Interpretation of 1937, interpreting the reasonable necessity test within the context of the U.S. securities markets that existed *seventy* years ago, and the stabilization requirements, adopted in response to the 1975 amendments ("1975 Amendments")[10] to the Exchange Act[11] and SEC rules promulgated thereunder, should never be changed. Of course, this comment utterly ignores the changes in the marketplace generally and on the NYSE specifically in the seven decades since Saperstein was issued and the more than *thirty-one* years since the 1975 Amendments. Nevertheless, the commenter suggests that no material changes exist warranting a re-examination of the specialist's negative obligation and stabilization requirements or the Saperstein Interpretation. For the commenter, the clock stopped in 1975: "if there was no need for Commission action in 1975, [addressing these issues] surely there is no need for such action today."[12]

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9 See Securities Exchange Act Release No. 51808, 70 FR 37469 (June 29, 2005).

10 Securities Acts Amendments of 1975("1975 Amendments"), Pub. L. No. 94-29, 89 Stat. 97.

11 15 U.S.C. 78a.

12 See Rutherfurd II at page 11.

Clearly, significant changes in competitive forces, customer expectations, technology, and automation have revolutionized the securities industry since 1975. The Commission commented upon this recently, in its adopting release for Reg. NMS:

> "For three decades, [since 1975] the Commission has adhered to… [the] guiding objectives in its regulation of the NMS, which are essential to meeting the investment needs of the public and reducing the cost of capital for listed companies. Over this period, the Commission has continued to revise and refine its NMS rules in light of changing market conditions…..
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> In recent years, the equity markets have experienced sweeping changes, ranging from new technologies to new types of markets to the initiation of trading in penny increments. The pressing need for NMS modernization to reflect these changes is inescapable….
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> * * * * *
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> The time has arrived, however, when decisions must be made and contentious issues must be resolved so that markets can move forward with certainty concerning their future regulatory environment and appropriately respond to fundamental economic and competitive forces….."
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> * * * * *

Securities Exchange Act Release No. 51808, 70 FR 37496 at 37497 (June 29, 2005).

Among the significant changes that have transformed the way in which the securities markets function are:[13]

(1) Establishment of the National Market System in 1975 mandating intermarket linkage, pursuant to newly-adopted §11A of the Exchange Act and the strengthening of the National market System under Reg. NMS;

(2) Creation of consolidated trade reporting, which provides a real-time data stream of last sale information, as required by Rule 601 of Reg. NMS (formerly SEC Rule 11Aa3-1). See also Exchange Rule 60;

(3) Adoption of the Quote Rule requiring the best bid and best offer of each market center to be disseminated to market data vendors, thereby making them publicly available and firm quote obligations with respect to such displayed quotation, as required by Rule 602 of Reg. NMS (formerly SEC Rule 11Ac1-1). See also Exchange Rule 60;

(4) Establishment of minimum display requirements for market data vendors, resulting in consolidated trade and quote information, as governed by Rule 603 of Reg. NMS

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[13] For a detailed review of the history of the negative obligation see George T. Simon and Kathryn M. Trkla, *The Regulation of Specialists and Implications for the Future*, 61 Bus. Lawyer 217 (2005).

(formerly SEC Rule 11Ac1-2). Additionally, NYSE OpenBook® provides real time access to limit orders entered on the Exchange;

(5) Adoption of the Limit Order Display Rule (Rule 604 of Reg. NMS, formerly SEC Rule 11Ac1-4), requiring market centers to immediately update displayed quotations upon receipt of bids and offers that improve the quoted price or materially change the size of the quote. See also Exchange Rule 79A.15;

(6) Creation of order protection rules prohibiting trading at a price worse than the best bid and offer displayed by another market center. Originally instituted under the Intermarket Trading System ("ITS") Plan,[14] in accordance with SEC Rule 11Aa3-2 (now Rule 608 of Reg. NMS), order protection requirements were strengthened in Rule 611 of Reg. NMS. See also Exchange Rule 15A;

(7) Adoption of requirements regarding the posting of locking and crossing quotations. These too were first instituted under the ITS Plan. They have been strengthened by Reg. NMS Rule 610. See also Exchange Rules 15A and 19;

(8) Adoption of Regulation SHO,[15] which, among other things, included a one year pilot suspending short-sale tick restrictions in a group of securities. The pilot, which was recently extended for another year[16] as a result of its positive results, signals the recognition that ticks no longer serve as useful benchmarks in regulating trading;

(9) Growth of alternative trading systems such as ECNs, electronic markets that operate like exchanges, but are regulated like broker/dealers[17] and crossing networks. Unlike NYSE specialists, market makers' principal transactions on these systems are not subject to the negative obligation or stabilization requirements;

(10) Approval of the NASDAQ Stock Market ("Nasdaq Exchange") as an exchange, requiring it to comply with all laws, rules and policies governing securities exchanges.[18] Like NYSE specialists, Nasdaq Exchange market makers are required to maintain continuous two-sided markets in their registered securities and are permitted to act as

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14 See Securities Exchange Act Release No. 14661 (April 17, 1978), 43 FR 17419 (April 24, 1978)

15 See Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004).

16 See Securities Exchange Act Release No. 53684 (April 20, 2006), 71 FR 24765 (April 26, 2006).

17 ECNs are governed by Regulation ATS, 17 CFR 242.300

18 See Securities Exchange Act Release No. 53128 (January13, 2006), 71 FR 3550 (Jan. 23, 2006).

brokers and dealers in those securities. As such, Nasdaq Exchange market makers are indistinguishable from NYSE specialists. However, unlike NYSE specialists, Nasdaq Exchange market makers are not compelled to comply with SEC Rule 11b-1's requirement that their principal trading in their registered securities be reasonably necessary. In other words, NYSE specialist trading in a registered security on the Exchange may only occur if such trades are in accordance with the negative obligation and stabilization requirements; a Nasdaq Exchange market maker's principal transaction at the same time in the same security trading on that exchange need only be part of a "course of dealings.…that assist in the maintenance, insofar as reasonably practicable, of fair and orderly markets.[19] To put it another way, if the last sale on the Exchange in XYZ is $20.50 and the quote is $20.52 - $20.54, the NYSE specialist in XYZ who wanted to establish a position in the stock in order to be able to fulfill its specialist obligations would not be able to take that offer (i.e. buy stock at $20.54) until approved to do so by a Floor Official; who would need to satisfy himself that the specialist's proposed trade is consistent with his or her negative obligations. While this process is going on, the Nasdaq Exchange market maker would have already swooped in and taken the offer, as well as additional liquidity at multiple higher prices, by sweeping up the book to a LRP and then repositioning his or her quotation at the new higher price, completely shutting out the specialist; and

(11) Creation of the NYSE Hybrid Market, which dramatically increased the electronic trading on the Exchange and provided Floor brokers with tools to enable them to compete with specialists more effectively. Notwithstanding the dramatically increased speed of trading and the increased order competition, specialists in the Hybrid Market will continue to be required to commit capital and add liquidity in order to bridge gaps in supply and demand, which keeps the market fair and orderly, reduces volatility, and encourages stable prices.

The transforming effects of these changes are legion. As a result, specialists no longer have a meaningful ability to direct or influence trading or control the quote. Instead, the market has become increasingly driven by limit orders and marked by a dramatic increase in competition, where competitors are not forced to abide by the same trading restrictions that NYSE specialists are required to follow. This creates an environment where the specialists are simply unable to compete. To apply outmoded tick-based requirements and unfeasible Floor Official approval to NYSE specialists is not only illogical but fundamentally inconsistent with the statutory requirement to provide for competition among markets. Specifically, Section 11A(a)(i)(C)(ii) of the Exchange Act provides in pertinent part, that "it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure… fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets…"

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[19] Id.at 559.

Although the commenter refuses to acknowledge the competition currently facing specialists, the current marketplace is dominated by professional traders – program traders, hedge funds, day traders and institutions – employing algorithmic trading and smart order routers, as well as increasingly internalizing order flow. Unlike in the past, NYSE specialists must now compete with upstairs liquidity providers and with multiple OTC dealers, crossing networks and ECNs, as well as with NYSE Floor brokers empowered with the new, more effective, electronic order types. These market participants have the ability to trade on these alternative systems while actively participating in trading on the Exchange. None of these market participates are constrained in their trading like the specialists. In addition, the expansion of unlisted trading privileges and dual listings enabling NYSE listed securities to be traded in many market centers, add to the competitive landscape.

Additionally, the changes noted above have virtually eliminated the informational and time and place advantages that specialists experienced in the past. In the market place of 2006, there is no meaningful tape delay – last sale prices and quotations are immediately available to all market participants. Moreover, the growth of internalization means that "upstairs" trading firms have similar or better informational "advantages" as specialists, yet are able to trade on this information instantaneously, without restrictions.

Accordingly, it is clear that the markets of 2006 and beyond require different rules regarding specialist trading than what was necessary in the past.

The Exchange acknowledges that specialists occupy a unique position in relation to other market participants. It is for this reason that specialists are subject to more regulatory obligations than other market participants. To that end, although specialist algorithms may be said to provide a slight informational advantage by having knowledge of orders as they enter Exchange systems, that knowledge does not deny other market participants an opportunity to interact with these orders. For example, pursuant to Exchange rules, specialists' algorithms may not interact with a non-marketable order until that order is publicly quoted; therefore, market participants have a similar opportunity to trade with that newly published bid or offer. Moreover, pursuant to Exchange rules, there is an Exchange imposed time delay[20] on specialists' algorithmic messages ability to "Hit the Bid" or "Take the Offer" in order to mitigate any potential time advantage to them. Similarly, specialists' algorithmic ability to interact with marketable incoming orders by providing price improvement and matching a better price posted by another market center, is subject to competition by firm Floor brokers who have a similar opportunity to interact with these orders. Further, Floor brokers' customer interest represented by marketable CAP-DI orders automatically convert and trade along with specialist principal transactions. Accordingly specialists' algorithms do not act as an impediment to competition among market participants. The Exchange therefore believes that the

[20] See Exchange Rule 104(b)(ii)(B)

Stabilization filing presents a moderated approach that provides appropriate flexibility that will allow specialists to continue to add value to the market place.

The proposed changes to the stabilization rules retain the requirement that specialist dealings be reasonably necessary for the maintenance of a fair and orderly market and that transactions with the trend of the market be accompanied by appropriate re-entry on the opposite side. Contrary to the commenter's description of specialists as "risk adverse intra-day "flip traders" who do not seek to hold positions, under the proposed stabilization rules, Exchange specialists do and will continue to assume risk by committing capital to cushion market volatility when all other market participants are trading with the trend and destabilizing the price of the security. They also recognize that in order for specialists to continue in this vital role, they must have the appropriate tools to compete.

As Congress recognized in 1975,

> "It might be well that with active competition among market makers and the elimination of the trading advantages specialists now enjoy such a restriction [as the reasonable necessity test] on specialists' dealings would become unnecessary."

S. Rep. No. 94-75 at 100 (1975).

<u>Comments Concerning Proposed Interpretation of Reasonable Necessity</u>

As noted above, the reasonable necessity of a specialist's principal transaction is based on a *seventy* year old SEC interpretation that requires the test be satisfied on a trade-by-trade basis, rather than a more holistic approach. The Exchange believes it is unacceptable to require specialists, alone among all dealers, including Nasdaq Exchange market makers, to operate under a *seventy* year old interpretation that does not address the realities of modern securities markets. According to the commenter, the regulation of specialists' trading, can never change. This ignores the specific recognition in SEC Rule 11b-1 that a specialist's trading pursuant to the negative obligation be restricted *so far as practicable* to that which is reasonably necessary to permit him to maintain a fair and orderly market. The marketplace is dynamic, constantly changing and improving. Regulation of the markets and its participants require the same.

Accordingly, the Stabilization filing proposes a reinterpretation of the negative obligation's reasonably necessity test, eliminating the requirement that each specialist principal trade meet a test of reasonable necessity.

Significantly, the Exchange is not requesting the elimination of the reasonable necessity test, contrary to the commenter's suggestion. Rather, the Exchange proposes to maintain the trade-by-trade analysis for Prohibited trades and Conditional trades in inactive securities under proposed Rule 104.10(5) and Conditional transactions pursuant to proposed Rule 104.10(6). In other words, when specialists are establishing or increasing a position and "Hitting the Bid" or "Taking the Offer" the reasonable necessity of those transactions will continue to be analyzed on a trade-by-trade basis as will transactions that fall within the definition of Prohibited Transactions. Rather, the Exchange seeks to reinterpret the reasonable necessity test for those transactions where a trade-by-trade analysis isn't meaningful. In its place, the Exchange would access the reasonable necessity of the specialist's trading within a broader context, using an approach based on an analysis of pattern and practice in the trading of specialty securities for the dealer account.

The Commenter suggests that an approach based on patterns and practices is unworkable. In the commenter's view a pattern and practice analysis will ultimately lead to customer disadvantage in that specialists will engage in "in and out profit taking that interferes with direct public interaction."[21] However, such a pattern of trading would in fact violate the specialist's negative obligation as it impedes the opportunity for public orders to be executed against each other without undue dealer intervention within the context of the current market. To that end the Exchange believes that a pattern and practice analysis provides the appropriate regulatory check on specialists.

<u>Comments Concerning Specialists' Ability to Trade Pursuant to Proposed Amendments</u>

The proposed amendments to the stabilization rules do not call for a rescission of the negative obligation or elimination of the stabilization requirements. Although the proposed rule changes modify specialists' ability to execute orders for the dealer account, it is by no means the "*revolution*[22]" that the commenter suggests. It is important to understand that inherent in the current stabilization rules is the ability of specialists to execute transactions that are designed to meet the reasonably anticipated needs of the market in his or her specialty security. Indeed, the commenter fails to acknowledge this in any of his letters.

Specifically, current Exchange Rule 104.10(3) provides, among other things, that the specialist's course of dealings may be for "immediate" disparity in supply and demand or for a disparity in supply and demand that is "reasonably to be anticipated." The Exchange proposal builds on this concept and provides detailed guidance to specialists on how they are to effect such transactions.

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21 <u>See</u> Rutherford II at page 15.

22 <u>Id</u>. at 7.

To that end, the proposed changes move away from defining stabilization in terms of the last sale, focusing instead on market conditions, the type of trade in question and the specialist's existing position. This recognizes that ticks no longer provide useful benchmarks in a rapidly changing market while retaining the specialists' obligation to make an assessment to ensure the reasonable necessity of such transactions.

The Exchange believes that the provisions governing Conditional Transactions appropriately balance the need of specialists to have more flexibility in trading in fast moving markets with the traditional requirements governing their non-stabilizing trading. In addition, the proposed amendments recognize that with respect to securities that are "active," as defined in proposed Exchange Rule 104.10(6), order flow, not specialist quoting determines price movements in the security. Even the commenter acknowledges this, noting "…order flow will dictate pricing, market direction…"[23]

Moreover, contrary to the commenter's suggestion, specialists do not have a monopoly on algorithmic trading nor does their access to electronic trading create an "uneven playing field."[24] Exchange rules do not prevent market participants from employing algorithmic-based trading strategies in connection with round-lot trading. The Hybrid Market provides all market participants with the ability to trade electronically. Customers are able to benefit from the use of e-Quotes and d-Quotes via their Floor brokers and can create or purchase their own algorithmic systems to generate orders that can be entered via NYSE SuperDot®. All orders entered on the Exchange will be executed, consistent with their instructions, in accordance with Exchange rules. No class of customers is advantaged or disadvantaged by these rules.

The Exchange firmly believes that the proposed amendments are appropriate in the context of the markets as they exist today, are consistent with securities laws and are in the public interest. The proposed amendments provide specialists with flexibility when interacting with published interest. There is no disadvantage to other market participants because all market participants are afforded an opportunity to interact with that published interest. Moreover, specialists trading continues to be subject to stricter regulatory requirements not imposed on other market participants. The Exchange therefore believes that the proposed changes will modernize the regulation of specialist trading while at the same time even the playing field between specialists and market makers in NYSE securities and provide appropriate flexibility to enable specialists to position themselves to provide more liquidity to counter market trends and thus moderate volatility.

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23 Rutherfurd II at page 15.

24 Id.at18.

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

Sincerely yours,