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Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File Number SR-NYSE-2008-116

Dear Ms. Morris:

RBC Capital Markets Corporation ("RBC") appreciates the opportunity to comment on the above-captioned proposed rule change of the New York Stock Exchange, Inc. ("NYSE" or "Exchange"), in which the Exchange proposes to amend and restrict usage of the NYSE odd-lot trading system. Currently, NYSE rules and information memos impose significant restrictions on the entry of odd-lot limit orders to the NYSE odd-lot trading system, particularly for program trading and similar strategies. By contrast, with the Commission's urging, similar restrictions have not been imposed on the entry of odd-lot market orders. In this rule change, the NYSE proposes to eliminate the distinction between odd-lot limit orders and odd-lot market orders, in the process effectively eliminating access to the odd-lot system for program trading and similar strategies. The proposed rule change is both burdensome and anti-competitive. Many of the provisions use such vague terms and ill-defined concepts as to render compliance with it impossible without simply foregoing use of the odd-lot system entirely. The proposal imposes limitations on access to NYSE systems that unfairly discriminate between member organizations. It imposes these burdens without empirical analysis, when far less burdensome alternatives are available. For these reasons, as more fully discussed below, the proposed rule change is inconsistent with the requirements of Section 6(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). If the Exchange cannot be persuaded to withdraw the filing, we strongly urge that it be disapproved by the Commission.

I. Background

For over 15 years, responding to persistent complaints from NYSE specialists (now called Designated Market Makers or DMMs), the Exchange taken a series of measures intended to limit or impede access to the odd-lot system by firms engaged in index arbitrage, program trading, day trading and similar strategies, reserving unfettered access to the system to small retail customers. The campaign is strongly reminiscent of attempts by the NASD in the early 1990's to offer access to its Small Order Execution System (SOES) solely to small retail customers, and to prevent "professional traders" from using the system.

As the Exchange recounts in its rule filing, following a modification of the execution protocol for odd-lots in 1991, the Exchange initially identified certain sharp or "abusive" practices (such as breaking up round lot orders into odd-lots) that it deemed to be inconsistent with the operation of

the odd-lot system. Restriction of these practices, outlined in NYSE Information Memo 91-29 (July 25, 1991), was not controversial. The following year, the Exchange began efforts to restrict access to the odd-lot trading system to perfectly lawful trading activities that it nevertheless considered to be inconsistent with the purely retail customer order flow it sought to accommodate through the odd-lot trading system. On May 19, 1992 it filed a proposed rule change that eventually culminated in Information Memo 94-14 (April 18, 1994). As described by the NYSE in the instant rule filing, Information Memo 94-14 largely precluded the use of the odd-lot system for entry of odd-lot **limit** orders related to index arbitrage, program trading and day trading strategies. By contrast, the filing noted that "such trading practices using odd-lot **market** orders were not precluded" (emphasis added). Significantly, the rule filing omitted to state why Information Memo 94-14 did not restrict the entry of odd-lot market orders for program trading and related strategies. In particular, the filing failed to reference the significance the Commission attached to permitting such odd-lot **market** orders in its determination that the limitation on odd-lot **limit** orders was appropriate. Here's what the Commission approval order said: "The NYSE has been careful in formulating the Information Memo to prohibit only those transactions that would abuse the odd-lot limit order execution guarantees. For example, the information memo does not preclude market participants from entering odd-lot market orders for index arbitrage, program trading, or day trading. Because the Commission believes the proposal clearly identifies and prohibits certain strategies that can result in abuse of the NYSE's odd-lot order system, yet still allows market participants to have such orders executed by entering odd-lot market orders rather than limit orders, the Commission believes that the proposal will not **unfairly limit access** to the NYSE's market." (*emphasis supplied*)[1]. While the NYSE claims that the use of the odd-lot system is intended to be confined to "the traditional odd-lot investing practices of smaller individual, retail investors," the fact of the matter is that SEC approval of the system has never been so limited.

In recent years, the NYSE has undertaken a variety of efforts to circumscribe use of the odd-lot system for index arbitrage and other program trading strategies. For example, in 2003 RBC received inquiries from and held discussions with Bob McSweeney and Catherine Kinney, two members of NYSE senior management. The focus of these discussions was on complaints the NYSE had received from specialist firms regarding our use of the odd-lot system. We were urged to reduce our usage of the odd-lot system in connection with index arbitrage and other program trading strategies even though such use consisted almost entirely of odd-lot market orders. Conversations at the time with other active program trading firms confirmed that they had received similar contacts from the NYSE. When we asked Catherine Kinney what the Exchange was doing to address inadequacies in the odd-lot system, we were told that the Exchange was undertaking efforts to integrate odd-lot order flow via the DOT system into the regular NYSE trading market. We were told that the Exchange expected to complete these efforts sometime in 2004.

Such a systems change did not occur. Instead, Exchange efforts remained focused on restricting use of the odd-lot system, rather than on modernizing the system. Specialist complaints about the use of the odd-lot system for program trading continued, and we received several inquiries from NYSE Market Surveillance into our odd-lot trading activity. Again, conversations with other active program trading firms confirmed that they, too, had received similar NYSE Market Surveillance inquiries.

Coinciding with these efforts, the NYSE issued additional Information Memos reiterating its stance that the odd-lot system is only to be used for "traditional" odd-lot orders. See Information

[1] Securities Exchange Act Release No. 34-33678, February 24, 1994

Memo from Market Surveillance dated March 19, 2004 ("March 2004 Information Memo"), and Information Memo 07-60 (June 29, 2007). Unlike Information Memo 94-14 and the current filing, neither of these information memos was filed as a proposed rule change. Rather, it appears the Exchange intended them as reminders regarding the policies, previously set forth in Information Memo 94-14, rather than setting forth any rule changes. These memos, in fact, do largely reiterate the prior information memo. Significantly, notwithstanding the clear dictate in the SEC's approval order that limitations on odd-lot market orders would constitute an unfair limitation on access to the NYSE market, neither of these Information Memos disclosed that entry of odd-lot market orders into the odd-lot system in connection with these strategies was permissible. Indeed, if read in isolation, these information memos would leave the clear impression that, other than on an "incidental" basis, the odd-lot system was entirely off-limits for such strategies.

For example, the March 2004 Information Memo began by stating that the odd-lot system was intended for the execution of "traditional odd-lot investing practices of smaller investors," and stated that "the Exchange has required that odd-lot activity by members and member organizations be consistent with traditional odd-lot practices, and that the system cannot be used as a professional trading vehicle." In addition to various "abusive" odd-lot practices, the March 2004 Information Memo then stated that member firms were not permitted to conduct "other types of trading activity in odd-lot orders that is not consistent with traditional odd-lot investment activity, including index arbitrage, certain types of program trading or any pattern of activity that would suggest day trading." The information memo went on to state that "Odd-lot limit orders may be entered as part of a program trade, provided such orders in the aggregate constitute a relatively small part of the overall program; a program consisting primarily of odd-lot orders is not permitted." Notably, the information memo was completely silent on the entry of odd-lot market orders for program trading.

Information Memo 07-60 is largely similar to the March 2004 Information Memo, with one addition. It begins with the familiar, if somewhat misleading, warning: "Use of the odd-lot system in ways that are inconsistent with traditional odd-lot investment activity or order entry practices that are intended to circumvent the round lot market constitute abuses of the odd-lot system and are prohibited." (emphasis in original) The information memo then lists various abusive practices that are not permitted. At the end of the list, it states that members are not permitted to engage in: "other types of trading activity in odd-lot orders or in PRLs that is not consistent with traditional odd-lot investment activity, including index arbitrage, certain types of program trading, security classes not usually involved in program trading (e.g., REITs, certain narrowly based structure (sic) products, etc.), or any pattern of activity that would suggest day trading or is otherwise suspicious because it is inconsistent with traditional odd-lot investment activity." It goes on to state that odd-lot limit orders may be entered in a program trade, provided they are a relatively small part of the program. But, like the March 2004 Information Memo, it fails entirely to note that program trades utilizing odd-lot market orders are not subject to this limitation. Information Memo 07-60 also introduced new questions about the permissibility of routing PRLs to the Exchange as part of program trading and other strategies, a matter discussed in Section III.B.5. below.

In the past three years, the NYSE has brought a series of enforcement actions related to the use of the odd-lot system.[2] The vast majority of the cases have been brought as a result of complaints by NYSE specialists.[3]

[2] See infra, note 14.

Without belaboring the point, the history of NYSE oversight and enforcement of the odd-lot system has been characterized by a steady and intensifying campaign effort to deter access to the odd-lot system in a manner explicitly authorized, indeed required to be permitted, by the SEC as a condition of its approval of the Exchange's operation of the odd-lot system.

II. Description of Proposed Rule Change

The proposed "rule" contained in the instant rule filing is a new Information Memo that would supersede Information Memo 94-14, as well as the 2004 and 2007 information memos. The proposed new information memo is a fairly lengthy 6-page narrative that is part background, part rationale, and part proscription. After recounting that "Information Memo 94-14 provides that certain trading practices that rely specifically on odd-lot limit orders, including index arbitrage, program trading and day trading, are prohibited," the proposed Information Memo acknowledges, without elaboration, that, "Under the terms of Information Memo 94-14, however, odd-lot market orders were not subject to the same restrictions."

The proposed Information Memo then asserts, "The distinction in the regulatory treatment of odd-lot limit orders and market orders as described in Information Memo 94-14 is no longer necessary or practical in today's market." The proposed Information Memo references the adoption of Regulation NMS, increases in trading volume and speed, and the availability of algorithmic trading and similar platforms. It states that NYSE Regulation has noted an increase in the use of odd-lot market orders in trading practices that, were they to use limit orders, would violate the Exchange's rules. It then declares: "These trading practices are designed to circumvent the auction market and access liquidity and/or pricing that is not otherwise available, or to create an unfair advantage over other market participants, and, as a result, threaten to undermine the economic viability of the odd-lot trading system and reduce the [Designated Market Makers'] willingness to provide cost-effective and efficient liquidity."

The next section of the proposed Information Memo describes practices to be prohibited. It begins by listing proscribed abusive practices: the failure to aggregate "certain odd-lot orders," "the use of odd-lot orders to capture the spread," "the entry of round-lot orders to create favourable execution prices for odd-lot orders," and "the use of odd-lot or partial round-lot (PRL) orders to effect prearranged or 'wash' sales." The filing then identifies activities which, while wholly legitimate, the Exchange deems to be "inconsistent with traditional or standard odd-lot investment activity, including index arbitrage, security classes not usually involved in program trading (e.g., REITs, certain narrowly based structure products, etc.) day trading, certain types of program trading, or certain professional trading platforms and strategies used by market professionals." The filing goes on to state: "In particular, the Exchange will consider the

[3] See, e.g., RBC Capital Markets Corporation (NYSE Hearing Board Decision 08-43, Sept 12, 2008) ("In December 2005, the On-Floor Surveillance Unit of NYSE Regulation's Division of Market Surveillance ('MKS') referred to Enforcement numerous complaints from various Specialist firms regarding odd-lot orders in several NYSE-listed securities, entered by RBC through [SuperDOT]."); Merrill Lynch (NYSE Hearing Board Decision 07-163, Dec. 20, 2007). (In the first half of 2005, [MKS] referred to Enforcement eight complaints from various Specialist firms regarding 'odd-lot transactions' in several NYSE-listed securities introduced to the NYSE by Merrill Lynch through [SuperDOT]."); Nasdaq Execution Services, LLC, f/k/a Brut, LLC (NYSE Hearing Board Decision 07-124) ("On October 3, 2005, [MKS] received from an NYSE specialist firm, an odd-lot order entry complaint insolving **NES....** On January 3, 2006, a representative of a NYSE specialist firm complained to OSFU about numerous odd-lot orders in XYZ..."). See also, Electronic Brokerage Systems, LLC (NYSE Hearing Board Decision 07-91, June 18, 2007); UBS Securities (NYSE Hearing Board Decision 07-10, Jan. 18, 2007); Harborview, LLC (NYSE Hearing Board Decision 06-192, Nov. 6, 2006); Bear Securities (NYSE Hearing Board Decision 06-122, June 18, 2006). Helfant Group, Inc. (NYSE Hearing Board Decision 06-37, May 10, 2006).

following activity to be violative: (i) a program or strategy that inappropriately uses odd-lot orders to access volume or obtain pricing that would not be available in the round-lot market, or (ii) a program or strategy that results in more than an incidental use of the odd-lot order system."

III. Objections to the NYSE Proposed Rule Change

The Commission should reject the proposed rule change. Contrary to the summary recitation in the "Statutory Basis" section of the Exchange's rule filing, we believe the proposed rule change does not "remove impediments to and perfect the mechanism of a free and open market," is not "in the public interest," does not "ensure economically efficient execution of securities transactions" and most certainly does not ensure "fair competition among brokers and dealers and among exchange markets." To the contrary, the proposed rule change does not address the fundamental issues about "unfairly limit[ing] access" that the Commission stated would have been a concern in Information Memo 94-14 had it not permitted entry of odd-lot market orders for index arbitrage and program trading. Key provisions in the proposed rule change are impermissibly vague. The proposed rule change also unfairly discriminates among members of the Exchange. For all of these reasons, as more fully discussed below, we urge the Commission to reject the proposed rule change. Should the NYSE not agree to withdraw the proposed rule change, we urge the Commission to commence disapproval proceedings.

A. The NYSE Proposal is Contrary to a Free and Open Market and the Public Interest, and Imposes Inappropriate Burdens on Competition

The NYSE proposal to restrict access to its odd-lot system by persons engaging in program trading and similar strategies bears a striking resemblance to the unsuccessful efforts of the NASD two decades ago to limit access to its Small Order Execution System (or "SOES") through adoption of a rule prohibiting access to SOES by "professional traders." The SEC's approval of the NASD Professional Trader rules was challenged and ultimately struck down by the D.C. Circuit Court in *Timpinaro v. SEC*[4]. In approving the NASD's SOES Professional Trader prohibition, the SEC in *Timpinaro*, accepting arguments advanced by the NASD, contended: "[I]f professional traders are not restrained from using SOES, there is a reasonable likelihood that more market makers will cease making markets, spreads will widen and liquidity will be negatively impacted."[5] The Court found, however, that neither the NASD nor the SEC had produced any evidence to support this contention: "[T]he record contains no empirical data showing that active SOES trading led market makers, before the new Rules were implemented, either to withdraw from dealing in some securities or to increase their spreads."[6] The Court concluded "that the SEC has not adequately substantiated its implicit claim that the effect of 'professional SOES trading' upon bid-ask spreads outweighs the beneficial effect of more timely pricing by market makers. We therefore remand this aspect of the case for the Commission to address the balance of benefits and costs associated with the Professional Trader Rule."[7]

The NYSE has sought to justify the instant proposed rule change on the grounds that strategies employing odd-lots for program trading and similar activities "are designed to circumvent the auction market and access liquidity and/or pricing that is not otherwise available, or to create an unfair advantage over other market participants, and, as a result, threaten to undermine the

[4] 2 F.3d 453, 303 U.S.App.D.C. 184 (D.C. Cir. Aug. 13, 1993)
[5] *Id.* at 458.
[6] Id.
[7] Id.

economic viability of the odd-lot trading system and reduce the [Designated Market Makers'] willingness to provide cost-effective and efficient liquidity." We disagree strongly with the

NYSE assertion. Investors who use the odd-lot trading system to execute odd-lot sized components of stock baskets are not trying to circumvent the auction market; they are sending the orders to the only NYSE facility in which the odd-lot sized components of basket orders can effectively be traded. If the NYSE incorporated odd-lots into its round lot trading systems, we would be delighted to have them routed and executed accordingly. Nor is there a basis for concluding that these odd-lot orders create unfair advantage over other market participants. Index arbitrage and other forms of program trading differ markedly from the spoofing and other abusive practices which the NYSE has quite correctly sought to curtail. Odd-lots associated with program trades are no more "unfair" than the round-lot trades that are part of the same programs. If any economic hardship is imposed on the DMMs who execute the orders, they are the consequence of an odd-lot trading system that is in need of updating.[8] Moreover, absent entirely from the rule filing is any discussion of the costs to persons employing program trading or other strategies from the limitations that would be imposed by the rule change, any attempt to quantify the harms to the DMMs or otherwise that the Exchange believes to arise under the current rules, or any cost-benefit analysis of those respective consequences.

The costs resulting from effectively denying persons employing program trading, index arbitrage and similar strategies access to the NYSE odd-lot system are clear (the NYSE filing would allow "incidental" use of the odd-lot system for such strategies; as discussed in Section III.B. below, however, even this limit permission may be largely illusory). Program trading takes a variety of forms, but most typically it represents an effort by a money manager, hedge fund or broker-dealer to effect trading that either tracks or is measured against the performance of a recognized securities index. To the extent performance lags or deviates from the established index, the money manager's performance may be called into question. Index arbitrage is an effort to profit from temporary discrepancies in the value of a futures contract, options contract, exchange-traded fund or related derivative security that tracks an index and the collective prices of each of the component stocks in the index. Where the stocks are relatively undervalued, the index arbitrageur seeks to lock in a profit by buying the basket of component stocks and selling the derivative; where the stocks are overvalued, the arbitraeguer sells the basket and buys the derivative. To the extent that a program trader or index arbitrageur is unable to buy or sell the component stocks in the precise proportion in which they are represented in the underlying index, they incur "basis" risk, the risk that their returns will vary from changes in the value of the index or that they will be unable to effectively lock in profits from the pricing disparities in the derivative and offsetting basket of stocks. For large program trades, the component stocks that comprise the largest portion of the index will all almost certainly be traded in round lot sizes. The smaller component stocks, however, may only be fairly represented in the basket in odd-lot

[8] In this regard, we have been advised by SIFMA staff that the NYSE has indicated informally to them that it hopes to replace the current odd-lot system sometime in 2009. We have been led to believe the new system would integrate odd-lots orders into the round-lot market. We would applaud such efforts. However, we also reserve judgement on the likelihood of this near-term implementation given the similar commitments NYSE senior management gave RBC over five years ago. In any event, the prospects of such incipient changes does not warrant imposing new restrictions on a 14-year-old regulatory regime at this point, especially without empirical support for the restrictions. Indeed, approving these new restrictions at this point would seem to remove a significant incentive on the Exchange to follow through and update these needed upgrades.

sizes. For smaller program trades, the number of stocks whose proportionate representation will be under 100 shares increases. Far from being isolated strategies, the NYSE's own data demonstrate that program trades constitute a substantial portion of the volume traded on the Exchange.[9]

In contrast to the pervasive and immediate adverse consequences would impose on investors employing program trading, index arbitrage and similar strategies, absent from the rule filing is any evidence whatsoever to document the Exchange's assertion that use of odd-lots in connection with such strategies threatens to "undermine the economic viability of the odd-lot trading system" or reduce DMMs' willingness to make markets. Nor is there any sort of analysis or evidence weighing the relative costs and benefits of the proposed change.

In one significant respect, the cost/benefit analysis of the NYSE's proposed odd-lot restrictions is far more lopsided than the Court's assessment of the SOES professional trading rule in *Timpinaro*. That difference relates to the absence of any meaningful alternative for the execution of odd-lots on the NYSE. In *Timpinaro*, the Court discussed at some length the fact that Professional Traders had the alternative of telephoning orders to market makers as an alternative to sending orders electronically via the SOES system. The Court in fact noted that the SEC had observed that non-SOES related trades actually appeared to exceed trades at the SOES 1000 share size limit or smaller.[10] Despite the availability of this manual execution alternative, the Court nevertheless overturned the SEC approval of the SOES Professional Trader rule. The cost-benefit analysis is even more skewed in the case of the NYSE's proposed odd-lot prohibition. In the proposed Information Memo, the NYSE states that the prior "distinction in the regulatory treatment of odd-lot limit and market orders as described in Information Memo 94-14 [prohibiting limit orders, but permitting market orders] is no longer **necessary** or practical in today's market" (emphasis added). The Exchange never explains why it is no longer necessary for persons engaging in program trading or similar strategies to be able to access the odd-lot system in other than an incidental way. The fact of the matter is that there does not exist any meaningful alternative for the execution of odd-lots on the NYSE away from the odd-lot system.

To approve the provisions of the proposed rule, the Commission must determine that they are designed to "facilitate[e] transactions in securities" and "to remove impediments to and perfect the mechanism of a free and open market." It must also determine that they "do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act]." The proposal impedes transactions, rather than facilitating them; it erects impediments to a free and open market; and it is anti-competitive. Under the clear analysis and findings in the *Timpinaro* case, the Exchange has not provided a basis upon which the Commission can make the statutory findings required under Section 6(b)(5) and 6(b)(8) of the Exchange Act for approval of the proposed rule change.

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[9] According to the NYSE's website, program trading has accounted for between 15% and 45% of weekly NYSE weekly share volume in the past year. Until 2006, program trading percentages were calculated by the NYSE by comparing program trading buys and sells as a percentage of overall NYSE trading volume. This produced weekly volume percentages as high as 90%, but undoubtedly overstated the transactions involving program trading, because it double-counted transactions in which programs were on both sides of the trade. Beginning in 2006, figure is now arrived at by adding together all of the program trading shares bought, sold and sold short as a percentage of all shares bought, sold and sold short, effectively cutting the reported program trading level in half. Using either method, it is clear that program trading is an important part of the NYSE listed market. See www.nyse.com/financials/1152267398806.html.

[10] Supra note 2, at 459.

B. The NYSE Proposed Rule Change is Impermissibly Vague

The boundaries of the limitations contained in the NYSE proposed rule change are undefined and unknowable. In this respect, the proposal also bears a strong resemblance to the rule struck down by the Court in *Timpinaro*. In that case, the Court found that: "Fully five of the seven factors to which a trader must attend if he is to avoid engaging in a 'professional trading pattern' are subject to seemingly open-ended interpretation. We refer to (1) a high volume of day trades in relation to all trades in the account; (2) a high volume of day trades in relation to all trades in the account; (3) a high volume of day trades in relation to the number and value of securities held in the account; (4) excessive frequency of short-term trading; and (5) excessive frequency of short sale transactions."[11] (*Id.* at 460.) The court explained the consequences of such vagueness: "A vague rule 'denies due process by imposing standards of conduct so indeterminate that it is impossible to ascertain just what will result in sanctions."[12] The consequences of a rule containing multiple vague provisions compounded the problem: "The uncertainties facing a trader who wants to avoid sanction is all the greater when these mysteries are considered in combination, according to some undisclosed system of relative weights."[13]

Vagueness issues arise throughout the "Information Memo" that constitutes the "rule" that the Exchange is seeking to adopt here. Specific provisions or elements of the proposed Information Memo that give rise to uncertainty include the following:

1. The proposed rule purports to prohibit "practices designed to circumvent the auction market and access liquidity and/or pricing that is not otherwise available, or that create an unfair advantage over other market participants." We are uncertain as to what is intended to be covered by the first phrase in this proscription. Any odd-lot order sent to the NYSE for execution will be routed automatically to the odd-lot system. A program trader who electronically routes a basket of stocks that mechanically and precisely tracks an index, and thereby has a substantial number of odd-lot sized components, hasn't designed the program to circumvent the NYSE auction market, any more than a full-service or discount broker-dealer that routes all of its retail odd-lot order flow in NYSE-listed securities to the Exchange. Both are equally aware that their perfectly legitimate odd-lot orders will be executed by the odd-lot system, neither has a nefarious "design" to circumvent the auction market. The second phrase of the prohibition—to "create an unfair advantage over other market participants"—is even more opaque. We are unable to divine any standard of conduct in a prohibition against practices "that create an unfair advantage" over other market participants. Perhaps this phrase is intended to cover spooking, breaking up round lots into odd-lots or other abusive practices. The rule filing does not at any point illuminate the circumstances in which a market participant who uses odd-lot market orders as part of a program trading, index arbitrage or other strategy (other than on an "incidental" basis) would thereby be obtaining an unfair advantage over other market participants.

2. The proposed rule change declares that "certain types of program trading or professional trading platforms and strategies are also violative." The filing does not, at that point, go on to indicate which types of program trading are violative, or what perhaps would have been more helpful, which types of program trading strategies are not violative. Nor does it elaborate on what a professional "trading platform" or professional "trading strategy" is, or on the kinds of

[11] Id. at 460.
[12] *Id.* (citations omitted.)
[13] *Id.*

professional trading platforms or professional trading strategies are among the "certain types" the rule proposal is seeking to outlaw. Finally, the rule filing does not give us a clue as to whom a "professional trader" is. Even though the Court in *Timpinaro* found the seven-factor definition of "Professional Trader" in the SOES rules to be unconstitutionally vague, at least the NASD attempted to define the term.

3. The proposed rule change seeks to limit access to the odd-lot system by "a program or strategy that inappropriately uses odd-lot orders to access volume or obtain pricing that would not be available in the round-lot market." This proscription, along with the one discussed in point 4. immediately below, is prefaced with a sentence that begins, "in particular". As is evident, though, no greater level of particularity is provided than with the standards discussed in the first two points. Left unexplained is what causes a program or any other strategy to "inappropriately" use odd-lot orders. A member firm is left to conjecture how, if at all, a program or strategy could be structured to "appropriately" use odd-lot orders to access volume or obtain pricing unavailable in the round-lot market.

4. The proposed rule change prohibits "a program or strategy that results in more than incidental use of the odd-lot order system." Nowhere is there a definition, or even a subjective description, of when the number or size of odd-lots in a program or strategy might be more than incidental. As discussed in the background section of this comment letter, the inclusion of an "incidental use" carve-out to the odd-lot limit order restriction has appeared in Exchange Information Memos going all the way back to Information Memo 94-14, but even that history leaves a wide gulf of uncertainty. In both the March 2004 Information Memo and Information Memo 07-60, there is a reiteration of the standard set out in Information Memo 94-14 that odd-lot limit orders may only be entered if, in the aggregate, they constitute a "relatively small part" of the overall program. The Information Memos further explain that programs consisting "primarily" of odd-lots are not allowed. If the NYSE is relying on the same analysis as its early pronouncements regarding odd-lot limit orders, a program that consisted more than 50% of odd-lots (apparently, but not necessarily, measured by the number of orders rather than the relative number of shares or dollar value of the orders) is presumptively violative. But where the line might be drawn between zero and 50% is open to conjecture.

5. The application of the prohibition to partial round lots (PRLs) is unclear. This is of particular concern to RBC. In an effort to address NYSE specialist (DMM) complaints, RBC has scaled back its use of odd-lot orders in most basket trades. We have, however, generally continued to use PRLs in constructing program baskets. The Exchange's recitation of practices prohibited by the proposed rule includes a reference to "the use of odd-lot or partial round-lot (PRL) orders to effect prearranged or 'wash' sales." The proposal does not otherwise reference PRLs, and its discussion of programs or strategies consistently refers only to "odd-lot orders" without any reference to PRLs. The proposal, however, also states that its prohibition extends to "a program or strategy that results in more than incidental **use** of the odd-lot order system" (emphasis added). It is our understanding that, when a PRL order is entered into the DOT system, for example, for 250 shares, the Exchange breaks that order into a round-lot component (200 shares), which it processes for execution via DOT within the auction market, and an odd-lot component (50 shares), which it processes for execution in the odd-lot system. As a result, orders that are not directed to the odd-lot system nevertheless may be deemed to "use" the odd-lot system. On the basis of the foregoing, we are unable to discern whether PRLs that are included in program trading or index arbitrage strategies unrelated to "wash" sales are covered by the rule.

6. In the roster of types of trading "inconsistent with traditional or standard odd-lot investment activity," and therefore prohibited, is trading involving "security classes not usually

involved in program trading (e.g., REITs, certain narrowly based structure[d] products, etc.)." The inclusion of this category of orders, which appeared for the first time in Information Memo 07-60's listing of prohibited odd-lot limit orders, is baffling. The Exchange did not provide any explanation in 2007 of the reason for this addition to the list of prohibited activities; nor does it amplify further in the instant rule filing. Hence, one is left to conjecture why it is inappropriate to route odd-lot orders to the Exchange both in program trades, and in stocks that are usually not included in program trades. The extent of the restriction is also emphatically open-ended, reinforced in a parenthetical that begins with "e.g." and ends with "etc." To take a simple example of the confusion this provision causes, there are indexes that track the performance of REIT stocks. If odd-lots in certain REIT stocks were sent to the Exchange that were an "incidental" part of a REIT program trade, it's unclear whether such odd-lots would be deemed to violate the proposed rule.

7. Compounding the vagueness issues discussed above is the nature of the proposed rule change itself. Rather than being set forth in a succinct rule, the proposed prohibition is contained in a long, rambling Information Memo that is part history, part justification and part description of prohibited conduct. Like the rule at issue in the *Timpinaro* decision, the vagueness of the specific passages in the Information Memo discussed above is compounded by the challenge posed in attempting to discern how those provisions might inter-relate.

As the Court noted in *Timpinaro*, a vague rule unconstitutionally denies due process because it makes it impossible to know what conduct will result in sanctions. The proposed Information Memo reinforces this concern: "The Exchange emphasizes that **any** pattern of activity that **suggests** improper use of the odd-lot order system will be investigated and, where appropriate, prosecuted" (emphasis added). This is not idle rhetoric. Since 2006, the NYSE has prosecuted at least 11 cases involving use of the odd-lot system by upstairs firms, making it one of the Exchange's more active prosecution programs.[14]

Nor do there appear to be many constraints on when the Exchange deems prosecution not to be appropriate. In only one material respect does the Exchange's proposed rule change relax the regulation of odd-lots. It proposes to amend NYSE Rule 411(b) to explicitly apply the requirement to aggregate odd-lot orders to regular trading hours from 9:30 a.m. to 4:00 p.m. The Exchange notes that systems capabilities for member firms make it difficult to aggregate odd-lot orders during the pre-opening period. Even though the Exchange recognizes this difficulty, and despite the fact neither NYSE Rule 411(b) nor any of the Exchange's Information Memos on the odd-lot system specifically stated that the rule applied to the pre-opening period, that did not prevent the Exchange, in exercise of its prosecutorial discretion, from imposing six figure fines against Merrill Lynch[15] and RBC[16] for violations (failuring to aggregate odd-lot orders) related almost entirely to the transmission of pre-opening odd-lot orders.

Many of the catch-phrases in the proposed Information Memo are not new. They have been applied to restrictions on odd-lot limit orders in the past. The potential harm from the vagueness of these provisions, however, was mitigated by the availability of the odd-lot system for market orders. At RBC, for example, we simply made the decision to avoid sending odd-lot limit orders

[14] NYSE Hearing Board Decisions 06-37 (Helfant Group, May 10, 2006); 06-122 (Bear Stearns, June 28, 2006); 06-160 (Pioneer Capital, Sept. 7, 2006); 06-171 (Sungard Global Execution, Sept. 11, 2006); 06-192 (Harborview, Nov. 6, 2006); 07-10 (UBS Securities, Jan. 18, 2007); 07-91 (Electronic Brokerage Systems, June 18, 2007); 07-124 (Nasdaq Execution, f/k/a/ Brut, Aug. 22, 2007); 07-145 (Interactive Brokers, Sept. 10, 2007); 07-163 (Merrill Lynch, Dec. 20, 2007), and 08-43 (RBC Capital Markets Corporation, Sept. 12, 2008).

[15] NYSE Hearing Board Decision 07-163, Dec. 20, 2007

[16] NYSE Hearing Board Decision 08-43, Sept. 12, 2008

associated with index arbitrage and other program trading strategies. In that way, the permission for "incidental use" was treated as a safety valve confined to isolated, one-off transactions and to errors. Now that the Exchange proposes to cut off this remaining avenue for execution of odd-lot orders, the consequences of the vagueness become much more acute.

C. The Proposed Rule Change Unfairly Discriminates among Members and Unfairly Limits Access to the Facilities of the Exchange

RBC believes the different levels of access afforded to different customers and dealers by the NYSE proposed rule requirement. Section 6(b)(5) of the Exchange Act provides that the rules of an exchange "may not permit any unfair discrimination among customers, issuers or dealers." While "traditional or standard" odd-lot investors are given unrestricted access to the NYSE's odd-lot system for the entry of both odd-lot limit orders and odd-lot market orders, persons who engage in program trading or any other professional strategy that results in more than incidental use of the system would be denied access to the odd-lot system for the entry of either odd-lot limit orders or odd-lot market orders. The NYSE could determine to cease to operate an odd-lot system entirely, or more preferably as Catherine Kinney committed to RBC representatives over five years ago and as apparently is being planned by the Exchange for the future, opt for a system that integrated odd-lot orders into the auction market. If the Exchange is intent on operating the odd-lot system as it is currently configured, it should not be permitted to pick and choose, granting unbridled access to the system for the "traditional" retail investors with whom its DMMs want to do business, while effectively blocking essentially all forms of access to the professional market participants the DMMs want to avoid. As the Commission found in 1994 in its approval of Information Memo 94-14, the provision of access to the odd-lot system to such professional participants through the entry of odd-lot market orders was necessary to prevent the limitations on use of odd-lot limit orders serving to unfairly limit access to the NYSE's market.

That the NYSE rule proposal would be structured in a manner that unfairly discriminates against upstairs firms and "professional" investors to the benefits of specialists/DMMs and the retail investors with whom they would rather trade is hardly surprising. As made clear in the background discussion in part I of this letter, the NYSE staff has been subjected to significant ongoing pressure by specialists/DMM to reduce "professional" trader use of the odd-lot system. By contrast, the NYSE staff has neither sought nor been responsive to the countervailing interests of firms engaging in program trading, index arbitrage and other wholly legitimate trading strategies whose activities would be adversely impacted by the proposal. In assessing the NASD's handling of the SOES Professional Trader Rules in the SEC's Section 21(a) report on the NASD and Nasdaq Market, the SEC observed that, "[t]he NASD staff was institutionally constrained from advocating in a balanced way the interests of all its constituencies."[17] A similar lack of balance has characterized the NYSE's consideration of access to and use of the odd-lot system.

[17] The SEC reported that: "The changes to the SOES rules from 1988 to 1994 consistently favored the interests of the market makers over those of the SOES firms. These rule changes largely evolved from concepts developed by market makers who proposed them to the NASD staff. The resulting rule changes were approved through the NASD's rulemaking process, which was largely influenced by firms that made markets. The NASD should have ensured that other interested member firms, investors, and issuers received adequate consideration in the rule making process." Appendix to Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market. Oct. 23. 2001 (modified), at page 83. While a Market Surveillance Committee of SIFMA has twice raised odd-lot system issues in meetings with the NYSE staff, the NYSE neither consulted with or informed the Committee or to our knowledge otherwise sought upstairs firm input in formulating the proposed rule change.

To justify the proposed limitations or access to the odd-lot system, the NYSE filing cited a number of features of the equities markets that have evolved since SEC approval of Information Memo 94-14, including the speed and volume of trading and the spread of algorithmic trading. Nevertheless, the Commission's concerns about unfair limitations on access are no less relevant today. In adopting Regulation ATS, the SEC imposed a graduated set of requirements on alternative trading systems ("ATSs") based on the volume levels they achieve. Small ATSs are not regulated in terms of access standards. Once an ATS reaches a consistent level of 5% or more of the average trading volume of a security, Paragraph (b)(5)(ii) of Regulation ATS states that the ATS must "not reasonably prohibit or limit any person in respect to access to services offered by such ATS" by applying its access standards "in an unfair or discriminatory manner." If such unfair access concerns exist for an ATS with just 5% or more of the volume in a security, how much more significant are the consequences of the denial of access by an Exchange which, despite reduced market share, continues to enjoy market share leadership in the securities it trades.

We appreciate the opportunity to comment on the proposed rule change, and would look forward to the opportunity to discuss the above comments, or any other questions regarding the Exchange's proposed rule, with the Commission staff.

Sincerely,

Richard T. Chase

Richard T. Chase

cc: Richard Ketchum
Fred Krieger
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