

March 20, 2012

**VIA E-MAIL AND FEDERAL EXPRESS**

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, NE.  
Washington, DC 20549-1090

Re: Securities Exchange Act Release No. 34-66346 (File Nos. SR-NYSE-2011-55 and SR-NYSEAmex-2011-84); Order Instituting Proceedings to Determine Whether to Disapprove Proposed Rule Changes, as Modified by Amendments No. 1, Adopting NYSE Rule 107C to Establish a Retail Liquidity Program for NYSE-Listed Securities and NYSE Amex Rule 107C to Establish a Retail Liquidity Program for NYSE Amex Equities Traded Securities--Comment and Rebuttal Letter (“Comment and Rebuttal”)

Dear Ms. Murphy:

NYSE Euronext on behalf of New York Stock Exchange LLC (“NYSE”) and NYSE Amex LLC (“NYSE Amex,” collectively with NYSE, the “Exchanges”) submit this letter in response to the grounds for disapproval identified by the Securities and Exchange Commission (the “SEC” or the “Commission”) in the above referenced proceeding and as a rebuttal to the one comment letter received by the Commission in the proceeding. The proceeding will determine whether the Commission disapproves the above-referenced proposed rule changes, which propose to establish a Retail Liquidity Program (the “Program” or the “Proposal”) on a pilot basis to attract additional retail order flow to the Exchanges by enhancing the price competition and transparency experienced by retail investors.

**I. Background**

On October 19, 2011, the Exchanges filed with the Commission a proposed rule change to establish on a one-year pilot basis a Retail Liquidity Program. The Program seeks to establish a venue for the execution of retail orders with greater price competition and transparency than existing execution arrangements.<sup>1</sup> Following a notice and comment period and a designation

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<sup>1</sup> See Securities Exchange Act Release No. 65671 (November 2, 2011), 76 FR 69774 (SR-NYSEAmex-2011-84); 65672 (November 2, 2011), 76 FR 69788 (SR-NYSE-2011-55).



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by the Commission on December 19, 2011, of a longer period for Commission action,<sup>2</sup> the Exchanges submitted a consolidated response on January 3, 2012,<sup>3</sup> to the 32 comment letters received, and Amendment No. 1 to the proposal on January 17, 2012. On February 7, 2012, the Commission issued an order instituting proceedings to determine whether to disapprove the proposal, as modified by Amendment No. 1 (“the February 7th Order”).<sup>4</sup>

The Commission stated in the February 7th Order that the proposal raised “novel market structure issues that warrant further comment and Commission consideration” and referenced the following as possible grounds for disapproval of the proposal: (1) the proposal’s inconsistency with the Sub-Penny Rule in allowing Retail Price Improvement Orders to be accepted and ranked in sub-penny increments; (2) the breadth of the proposal’s definition of Retail Orders; and (3) the precision of the description of the Program’s liquidity flag. The Commission stated that the Exchanges should provide additional detail regarding the proposed liquidity flag to “allow the Commission and commenters to assess whether the Quote Rule is implicated and, if so, to understand whether the Exchanges intend to comply with or seek an exemption from some or all of its requirements.”<sup>5</sup>

Concurrently with the initial filing of the proposal on October 19, 2011, the Exchanges filed a request for exemptive relief under the Sub-Penny Rule describing the Program’s consistency with the policy objectives of the Sub-Penny Rule and its furtherance of the public interest and protection of investors.<sup>6</sup> The Exchanges amended the request for exemptive relief on January 13, 2012.<sup>7</sup> On February 16, 2012, the Exchanges filed Amendment No. 2 to the proposal, which (1) narrows the scope of the Program’s definition of Retail Order to address the concerns expressed by the February 7<sup>th</sup> Order, and (2) provides clarifying details with respect to the Program’s proposed liquidity flag.<sup>8</sup> Finally, the Exchanges expect to file shortly a

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<sup>2</sup> See Securities Exchange Act Release No. 66003, 76 FR 80445 (December 23, 2011).

<sup>3</sup> See Letter to the Commission from Janet McGinness, Senior Vice President—Legal & Corporate Secretary, Legal & Government Affairs, NYSE Euronext, dated January 3, 2012 (“Exchanges’ Response Letter”).

<sup>4</sup> See Securities Exchange Act Release No. 66346, 77 FR 7628 (February 13, 2012) (“Order Instituting Proceedings”).

<sup>5</sup> *Id.* at 7633.

<sup>6</sup> See Letter from Janet M. McGinness, Senior Vice President—Legal & Corporate Secretary, Office of the General Counsel, NYSE Euronext to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission dated October 19, 2011 (“Sub-Penny Rule Exemption Request”).

<sup>7</sup> See Letter from Janet M. McGinness, Senior Vice President—Legal & Corporate Secretary, Office of the General Counsel, NYSE Euronext to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission dated January 13, 2012 (“Amended Sub-Penny Rule Exemption Request”).

<sup>8</sup> See Securities Exchange Act Release No. 66464 (February 28, 2012), 77 FR 13170 (SR-NYSE-2012-13).



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request for no-action relief that sets forth why the liquidity flag is not a bid or offer or quotation subject to the Quote Rule and why, even if it could be considered to be equivalent to a quotation, the Program would serve to protect investors and enhance competition and is therefore entitled to no-action relief. The Exchanges believe that with this letter and the request for no-action relief, they will have fully addressed all concerns identified by the Commission, the commenters, and the staff.

## **II. Summary of the Retail Liquidity Program**

As discussed more fully in the above-referenced filings, the Exchanges have proposed the Program to attract additional retail order flow to the Exchanges for NYSE and NYSE Amex traded securities while also providing the potential for price improvement to such order flow. The Program would create two new classes of market participants: Retail Member Organizations (“RMO”) and Retail Liquidity Providers (“RLP”). An RMO is a member organization approved by the Exchanges to submit Retail Orders. An RLP is a member organization approved by the Exchanges that agrees to provide liquidity to interact with orders submitted by RMOs with at least a minimum amount of price improvement, currently specified at \$.001 per share.

Importantly, liquidity providers under the Program would compete for execution priority with respect to incoming Retail Orders. A given liquidity provider, in other words, would not be assured of its ability to interact with an incoming order because a competing liquidity provider offering greater price improvement to the Retail Order would achieve execution priority with its more competitive order. The competition between liquidity providers together with the price-time priority of the Program would incentivize liquidity providers to *make new, more aggressive prices* than those currently available to retail investors.

The Exchanges would disseminate a Retail Liquidity Identifier (“RLI”) when interest priced \$.001 better than the protected best bid (PBB) or protected best offer (PBO) is available. RLIs would contain symbol and side (buy or sell) but would not contain prices or size. The Program would be limited to trades occurring at prices equal to or greater than \$1.00 per share. Similarly, the RLI would enhance the information about liquidity seeking to interact with retail investors that is available today, and therefore would potentially stimulate the price competition for retail order flow and deliver better prices to retail investors.

As proposed, the Program would be a pilot, extending twelve months from the date of implementation. The pilot would allow the Exchanges and the Commission an opportunity to assess its operation and impact.



### **III. Response to Grounds for Disapproval Under Consideration Identified by the Commission's Order Instituting Proceedings**

#### **A. The Program is consistent with the goals of the Sub-Penny Rule.**

The February 7th Order states that the proposal is inconsistent with the Sub-Penny Rule because the Program contemplates the Exchanges accepting and ranking orders in securities priced at \$1.00 or more per share in sub-penny increments. As noted above, the Exchanges have filed an Amended Sub-Penny Rule Exemption Request that discusses extensively the consistency of the Program with the regulatory purpose and policy goals of the Sub-Penny Rule, and have addressed issues related to the Sub-Penny Rule identified by commenters on the proposal in a consolidated response to comments.<sup>9</sup> The Exchanges request that the Amended Sub-Penny Rule Exemption Request and the consolidated response to comments on the proposal be incorporated by reference to this Comment and Rebuttal.

By way of summary, the Exchanges note that at the core of the Sub-Penny Rule's purpose was the Commission's concern with the potential of sub-penny increments to erode the incentives of investors to display limit orders. The Commission proposed the Rule in an effort to "limit the ability of a market participant to gain execution priority over a competing limit order by stepping ahead by an economically insignificant amount."<sup>10</sup> Both this core concern and the additional concerns related to liquidity, best execution, capacity, and fragmentation relate to *sub-penny quoting and not sub-penny trading*. Under the Program, neither Retail Orders nor RPIs will be displayed by the Exchanges. The nature of the proposed order types therefore simply do not give rise to the concerns addressed by the Sub-Penny Rule. Specifically, because RPIs are undisplayed (and because the RLI is unpriced), there is no possibility of RPIs gaining execution priority against a displayed public limit order that they do not already have under the current market structure. The Program would therefore not jeopardize the incentives to place limit orders or otherwise implicate the customer protection, capacity, best execution, liquidity, and fragmentation concerns addressed by the Sub-Penny Rule.

Moreover, while the Exchanges would "accept" and "rank" non-displayed RPIs using increments less than the minimum pricing increment as described above, doing so would in no way undermine the purpose or framework of the Sub-Penny Rule. Indeed, the prohibition on the acceptance and ranking based on sub-pennies was directed at the practice of private sub-penny display that had developed on ECNs in the wake of decimalization.<sup>11</sup> Some ECNs during that period were accepting, ranking, and privately displaying sub-penny orders to

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<sup>9</sup> See Amended Sub-Penny Exemption Request; Exchanges' Response Letter.

<sup>10</sup> Securities Exchange Act Release No. 34-51808, 70 Fed. Reg. 37496, 37551 (June 29, 2005) ("NMS Adopting Release").

<sup>11</sup> Securities Exchange Act Release No. 34-49325, 69 Fed. Reg. 11126, 11163-64 (Mar. 9, 2004) ("NMS Proposing Release"). The Commission noted the "growing trend in the industry, particularly among ECNs, to display quotations in their proprietary systems in sub-pennies . . ." *Id.* at 11163.



subscribers while at the same time (then pre-exchange) Nasdaq and the Exchanges were requiring their members to quote in pennies and the public quote stream reflected those quotes only in pennies. The Commission expressed concern that this lack of uniformity was “creating hidden markets whereby sophisticated traders [could] view and access better prices than those available to the general public.”<sup>12</sup> The Sub-Penny Rule’s prohibition on accepting and ranking sub-penny orders is therefore best understood as an effort to address and prevent the development of private or hidden markets with better-priced sub-penny orders.

Because RPI prices would remain at all times entirely non-displayed, they present no risk that a hidden sub-penny market would develop that would benefit professionals and disadvantage the public. Rather, the whole point of the Retail Liquidity Program is *to make better prices available to retail investors*. As will be discussed more fully in the Exchanges’ request for no-action relief from the Quote Rule, the Program’s liquidity flag would serve this goal directly by providing information about liquidity seeking to interact with retail investors where almost none is available today, thereby potentially stimulating the price competition for retail order flow.

**B. The Program’s Definition of Retail Orders is Now Strictly Limited to Natural Persons.**

In the February 7th Order, the Commission stated that the breadth of the proposed definition of a “Retail Order” raised questions “as to the scope of the exemption under the Sub-Penny Rule, and whether the Exchanges have fairly and reasonably determined the subset of market participants that would be allowed to access Retail Price Improvement Orders.” In response to the Commission’s concern, the Exchanges filed Amendment No. 2, which eliminated from the definition of “Retail Order” proprietary orders of RMOs that result from liquidating a position acquired from the internalization of orders. As a result, a “Retail Order” would be limited to “an agency order that originates from a natural person and is submitted to the Exchange by an RMO, provided that no change is made to the terms of the order with respect to price or side of market and the order does not originate from a trading algorithm or any other computerized methodology.”

**C. Amendment No. 2 to the Proposal Addresses the Commission’s Request for Additional Information About the RLI, and the Exchange’s Request for No-Action Relief Will Address the RLI’s Potential Quote Rule Implications More Fully.**

The Commission also asked that the Exchanges provide additional information regarding the proposed RLI. Amendment No. 2 would amend proposed Rule 107C(j), adding to the definition of the RLI that the identifier shall reflect the symbol for the particular security and the side (buy or sell) of the RPI interest, but shall not include the price or size of the RPI interest.

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<sup>12</sup> *Id.* at 11171.



Additionally, the Commission raised concerns that the RLI could fall within the definition of “bid or offer” in Rule 600(b)(8) of Regulation NMS, which would implicate Rule 602 of Regulation NMS (“Quote Rule”). The Exchanges submit that the Program is consistent with the Quote Rule because the RLI does not contain a price, and is therefore not a bid or offer or quote. Even if the RLI was considered to be substantially equivalent to a quotation, the Program’s potential to improve price competition for retail orders and deliver better prices to retail investors squarely favor providing the Program relief from the Quote Rule.

First, as noted above, liquidity providers under the Program would compete for execution priority with respect to incoming Retail Orders. The competition between liquidity providers, and the price-time priority of the Program, would incentivize liquidity providers to *make new, more aggressive prices* than those currently available to retail investors.

Second, the Program, and in particular the proposed RLI, would enhance the quality of pricing information available to market participants. Current internalization arrangements do not depend in any meaningful way on the displayed quotes of the broker-dealers interacting with retail order flow. There is, consequently, relatively little quotation or pre-trade pricing information related to those arrangements currently available to those routing retail orders. The Program’s dissemination of a liquidity flag identifying the presence of RPIs would represent an important advance in pre-trade transparency within the current retail order execution segment.

Third, the Program represents a competitive response on the part of the Exchanges to bilateral internalization arrangements, and offers the potential of continued and beneficial competition in the retail execution segment. To the extent that liquidity providers decide to compete with the Program rather than within the Program for retail orders, that competition, presumably fuelled with execution quality data, will present brokers handling retail orders with choices. If, for example, liquidity providers wish to provide either proprietary or more generally disseminated liquidity flags such as the RLI to advertise appropriately liquidity they are willing to provide, those choices will be even more fully informed. With more execution choices and more information, brokers handling retail orders will be in a position to drive a higher level of price competition for retail orders to the benefit of retail investors.

#### **IV. Rebuttal of the Comment Letter**

The Commission has recognized the direct connection between the ability of exchanges to innovate and the interests of investors:

Enhancing the SROs’ ability to implement and to respond quickly to changes in the marketplace should encourage innovation and better services to investors, such as further automating the execution of trades. Investors should also benefit from a





competitive environment in which SROs may easily adapt their trading rules to respond to market opportunities.<sup>13</sup>

As we stated in our Response to Comments, the Exchanges do not point this connection out to object in any way to their obligations to submit an initiative such as the Program to the comment process and the Commission’s review and approval. We embrace our roles as SROs, and our proposals typically benefit substantially from thoughtful comments received in response to them. We do respectfully object, however, to the tone of the one comment received in the proceeding (“the comment”).<sup>14</sup>

The Exchanges would note in particular how disconnected the commenter’s featured point—that “the NYSE Simply Seeks Market Share”<sup>15</sup>—is from the dynamic regulatory and competitive context that has unfolded in our equity markets over the previous decade. With regard to that context, we would simply offer this: we operate within a National Market System specifically designed by Congress to “evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed.”<sup>16</sup> Few, if any, market participants can claim to have been reshaped more fundamentally by competitive forces over the last decade than the Exchanges. That we seek to compete is axiomatic. That we have fully embraced the challenge of relentless competition with all its benefits and burdens is obvious. *How* we seek to compete is what is at issue in this proceeding. We have proposed a carefully designed Program that has the potential on its face to stimulate price competition for retail orders and to fuel that competition with a liquidity flag that substantially enhances pre-trade transparency. The product of the Program, if successful, would be better prices for retail investors. Dismissing the Program as a discriminatory, monopolistic grab for market share adds nothing of merit to the present proceeding and ignores the realities of today’s highly competitive market structure.

**A. The comment misconstrues the standard by which the Commission reviews exchange proposals.**

It is important to note at the outset that the commenter seeks to apply a standard of review to the Program that has no basis in the Exchange Act, and that indeed would stifle the innovation upon which the National Market System relies. In particular, the commenter contends that “[t]he proposed rule is not designed to cure a deficiency in market structure or to protect investors, but rather it is strictly a business initiative designed to help the NYSE acquire

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<sup>13</sup> Rule 19b-6 Proposing Release at 8912.

<sup>14</sup> Letter from Leonard J. Amoruso, General Counsel, Knight, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated March 7, 2012 (“Comment”).

<sup>15</sup> Comment at 2-3.

<sup>16</sup> Securities Exchange Act Release No. 34-51808, 70 Fed. Reg. 37496, 37633 (June 29, 2005) (“NMS Adopting Release”); see H.R. Rep. No. 94-229, 94th Cong., 1st Sess. (1975) (“Conference Report”), at 92.



market share.”<sup>17</sup> Section 6(b)(5) of the Exchange Act<sup>18</sup> sets the appropriate standard by which the proposal should be reviewed. As the Commission noted in the February 7th order, the question in this proceeding is whether the Proposal would promote just and equitable principles of trade, perfect the mechanism of a free and open market and a national market system, protect investors and the public interest, and not permit unfair discrimination.<sup>19</sup> As the Exchanges have demonstrated, the Program has the potential to enhance price competition for retail orders and pre-trade transparency associated with the currently segmented retail order execution segment. In doing so, the Program has the potential to deliver better prices to retail investors. For these reasons alone, the Program satisfies the standard set by the Exchange Act.

Beyond that, the Program’s expected benefits illustrate the importance of the connection identified by the Commission between exchange innovation and the interests of investors.<sup>20</sup> In fact, our ability “to respond quickly to changes in the marketplace” is another way of describing our readiness to meet promptly the demands of investors. In contrast, to suggest that exchange proposals should be disapproved if they are not “designed to cure a deficiency in market structure” is, in effect, to interpose obstacles to exchange innovation and deny investors its benefits. Moreover, characterizing the Proposal as a “business initiative” does nothing to undermine its merits. It is difficult to imagine how an effort to deliver “better services to investors”<sup>21</sup> could be anything but a business initiative in today’s highly competitive market structure.

**B. The Program is likely to provide the Commission useful data.**

The commenter asserts that the proposed pilot is “flawed” because it will consist of securities traded on a single market venue and thus “is unlikely to reveal any useful data.”<sup>22</sup> To the contrary, if the Program operates as anticipated, it has the potential to give the Commission a clear view of how price competition within the Program operates and how it compares with bilateral internalization arrangements. If the Exchanges’ expectation of broad participation in the Program across their extensive membership is met, this data, particularly the effect of the Program’s requirement that liquidity providers compete for execution priority on the prices delivered to retail investors, could illuminate important competitive dynamics.

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<sup>17</sup> Comment at 2.

<sup>18</sup> 15 U.S.C. § 78f(b)(5) (2011).

<sup>19</sup> February 7th Order at 22-23.

<sup>20</sup> *See supra* at 5.

<sup>21</sup> Exchange Act Release No. 34-43860, 66 FR 8912, 8912 (February 5, 2001) (“19b-6 Proposing Release”).

<sup>22</sup> Comment at 3.





**C. The Program will not undermine the objectives of the Quote Rule.**

The commenter also claims that the Program could undermine the objectives of Rule 602 of Regulation NMS (the “Quote Rule”) because “the ‘best’ order (i.e. the sub-penny orders resting on the NYSE’s book) under the ...Program would not be displayed.”<sup>23</sup> As set forth above and in the Exchanges’ Response Letter,<sup>24</sup> the Quote Rule is not implicated because neither the RLI nor the Retail Price Improvement Orders are bids or offers or quotations. The RLI does not contain a price, and Retail Price Improvement Orders are not displayed. As discussed above, even if the RLI were the substantial equivalent of a quotation, the significant benefits that the Program would offer to retail investors together with its potential to enhance competition and transparency in the retail execution segment would justify relief from the Quote Rule.

**D. The Program is consistent with the policy goals underlying the Sub-Penny Rule.**

The commenter also contends that the Program represents a material departure from Rule 612 of Regulation NMS (the “Sub-Penny Rule”).<sup>25</sup> The Exchanges acknowledge that the Program would require an exemption from the Sub-Penny Rule and filed a request for such relief concurrently with their initial filing. As set forth in the Amended Sub-Penny Rule Exemptive Request and the Exchanges’ Response Letter, the Exchanges’ believe that the Program is consistent with the objectives of the Sub-Penny Rule and otherwise deserving of exemptive relief,<sup>26</sup> and will foster competition on public markets for retail orders, making better prices available to the general public.

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<sup>23</sup> Comment at 3.

<sup>24</sup> See Exchanges’ Response Letter at 6-8.

<sup>25</sup> Comment at 4.

<sup>26</sup> The commenter states that the Exchanges have not responded adequately to issues related to the potential costs of sub-penny increments identified by the Commission in the Regulation NMS Adopting Release. The commenter points to: “depriving markets of liquidity; sub-penny jumping; decreasing depth of markets; and degradation of the quote.” (Footnote omitted.) The Exchanges believe they have dealt with all of these potential costs in both the Amended Sub-Penny Rule Exemptive Request and the Exchanges’ Response Letter. In brief, these concerns stem from either (1) the loss by a displayed limit order of execution priority to a competing displayed order that is better by an economically insignificant amount; or (2) the development of private markets with private quote fees which make better prices available to professionals than those available to the public. As discussed herein, in the Amended Sub-Penny Rule Exemptive Request and the Exchanges’ Response Letter, neither of those concerns is implicated by the Program.



**E. The Program is a competitive effort on the part of the Exchanges to better serve retail investors.**

The final contention made by the commenter is that approval of the Program will grant the Exchanges “a pricing convention monopoly,” which will unfairly tilt the competitive playing field in favor of the Exchanges.<sup>27</sup> The commenter suggests the Commission consider “whether a more broad-based application of the proposal among a wider group of market participants is appropriate, subject to thorough comment and analysis . . . .”<sup>28</sup> The Exchanges are at a loss as to how to respond to this suggestion. It is either a call to degrade any potential competitive benefit the Exchanges might earn from the considerable effort and expense they have committed to designing and seeking approval for the Program, or an effort to delay the Program, or both. In any event, retail investors would be the losers if the approach were adopted in that the benefits the Program would offer would be stifled by delay, comment, and analysis. The Program is an effort on the Exchanges part to embrace a “competitive environment in which SROs may easily adapt their trading rules to respond to market opportunities.”<sup>29</sup> It is an effort to provide “better services to investors.”<sup>30</sup> It is precisely the kind of innovation that the Commission has recognized as integrally connected to the public interest. To delay approval of the Program on grounds such as these is to upend, quite directly, the incentives of exchanges to innovate.<sup>31</sup>

**V. Conclusion**

Because the Program is an important component of the Exchanges' effort to innovate and compete with exchange and non-exchange markets for retail orders, because it offers the

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<sup>27</sup> Comment at 5.

<sup>28</sup> Comment at 5.

<sup>29</sup> 19b-6 Adopting Release at 8912.

<sup>30</sup> *Id.*

<sup>31</sup> There is nothing monopolistic about the pricing or other dimensions of the Program. Competing equity exchanges are free to formulate their own proposals to enhance price competition and transparency in the retail execution segment and seek appropriate relief as the Exchanges have done. Similarly, the Exchanges look forward to a broad participation of liquidity providers who wish to compete for retail orders within the Program. To the extent that non-exchange liquidity providers or markets seek to formulate appropriate competing proposals to enhance price competition and transparency, the Exchanges also welcome that competition. Needless to say, the National Market System provides plenty of space for competing execution venues and display mechanisms.



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potential to improve the prices received by retail orders and because it would present no meaningful operational, capacity, regulatory or other concerns, the Exchanges respectfully request that the Commission approve the Proposal.

Very truly yours,

A handwritten signature in blue ink that reads "Janet McInnes". The signature is written in a cursive style with a large initial 'J'.